# *The* New York Certified Public Accountant



VOL. XXIII *March · 1953* No. 3



*Society and Editorial Offices:* 677 Fifth Avenue, New York 22, N. Y.

## BOOK REVIEWS

### Encyclopedic Dictionary of Business

Prepared by the Editorial Staff of PRENTICE-HALL, INC., New York, N. Y., 1952. Pages: 704; $10.00.

This is a unique book. It is designed to provide information quickly on terms, procedures, and other aspects of certain businesses and professions, and as to administrative functions common to all businesses. The Dictionary covers the broad fields of accounting, advertising, business forecasting, correspondence, credits and collections, finance, foreign trade, industrial relations, insurance, law, marketing, mathematics, office management, purchasing, real estate, retailing, regulation of business, sales management, taxes, and traffic management.

On the whole, the material is presented in a manner not too technical for general reference. Some subjects are dealt with rather comprehensively (for a practical dictionary), with illustrations and charts, others are referred to rather sketchily. For example, close to six pages (including pictures) are devoted to the subject of shipping containers, whereas estate planning was allotted about one half a page, inadequately explained, and no reference made to the problem of related taxes.

Despite the noted shortcomings, which are perhaps inevitable in a book of this sort, particularly the first edition, professionals and business executives will nevertheless find a great deal of useful information in this Dictionary. More than 3,000 items are covered in its 700 pages.

Accountants will find explanations of terms and procedures common to the law and business, and descriptions of business management techniques. This can be useful where the accountant strives to act as a business advisor and consultant. Another subject of interest and value is the explanation of important business laws such as the Taft-Hartley Act, Sherman Act, Robinson-Patman Act, Securities and Exchange Act, and a number of other laws on which accountants should be reasonably well informed.

The book is not an encyclopedia, with the most detailed explanation of every term listed. Nor is it merely a dictionary containing definitions alone. It is a combination of both and it therefore may serve to answer many of the every-day questions that arise.

MAX BLOCK

New York, N. Y.

### Financial Statement Analysis (Second Edition)

By John N. Myer. PRENTICE-HALL, INC., New York, N. Y., 1952. Pages: XV + 272, $4.50.

This is the second edition of a book originally published by Prentice-Hall in 1941.

(Continued on page 176)

## *Reminder of*

# 1953 PRIZE ESSAY CONTEST!

The Board of Directors of the Society has authorized the Committee on Publications to conduct a prize essay contest among seniors and graduate students majoring in accountancy, duly enrolled in the colleges of New York State. The article may cover any topic in the field of accounting and/or auditing.

Prizes in the amount of $100 for the best article and $50 for the second best article are offered. In addition, the two winners and any others submitting papers worthy of honorable mention will receive a one-year subscription to *The New York Certified Public Accountant.*

The General Rules of the Contest are as follows:

All papers shall be original, and the manuscript shall be typed in duplicate on 8½ x 11 stationery on one side, double or triple space typing, and shall not be more than 6,000 words in length. Each contestant shall indicate the exact number of words in his paper at the end thereof.

★

The name of the individual submitting the paper shall not appear thereon, nor should there be any other means of identifying the manuscript, which should be accompanied by a covering letter giving the contestant's name and address. When submitted to the judges, each manuscript will be given a key number for identification.

★

Manuscripts should be forwarded to The Managing Editor of *The New York Certified Public Accountant,* 677 Fifth Avenue, New York 22, N. Y., on or before May 15, 1953. Awards will be announced as soon thereafter as possible.

★

All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in *The New York Certified Public Accountant.* The decision of the judges shall be final as to what papers, if any, may be entitled to prizes.

## BOOK REVIEWS

(Continued from page 172)

The present work does not differ materially from its excellent predecessor in concept or in scope, but several chapters have been entirely rewritten, terminology has been modernized throughout, and the entire book shows evidence of having been closely re-edited.

The change most evident in the present edition is the elimination of the third chapter of the original book, "Common Defects in Financial Statements," and the substitution of a new chapter, "Trends in Accounting Principles and Procedures."

The book is divided into two parts: Part One, "The Problem and Its Setting," and Part Two, "The Technique of Financial Statement Analysis."

Part One consists of a sixty-five page outline covering in rapid order the historical development of financial statements, the evolution of ratio anlaysis, the structure and limitations of the balance sheet and income statement, and the current financial reporting problems raised by the impact of inflation.

The author uses the newer terminology in statement presentation, the semantic evolution of which is recognized as the evidence of the refinement of the underlying concept. For example, the reasons why the term, "financial position," has generally superseded "financial condition" are very clearly exposited.

Part One, then, offers a brief but valuable critique of the meaning, uses and limitations of financial statements. It gives the student who is perhaps fresh from the second-year accounting course an opportunity to reappraise and crystalize his ideas about the nature of financial statements. It is regrettable that the author did not feel it worthwhile to expand his succinct discussion to include a more elaborate treatment of some of the interesting topics he raises. This reviewer would have welcomed a fuller analysis of the Clean Surplus Theory than is possible in the single paragraph devoted to it on page 53; a complete chapter delineating its history and significance from the analyst's viewpoint would have been very useful.

Part Two succeeds in presenting a detailed exposition of the tools available to the state-

(Continued on page 177)

## BOOK REVIEWS

(Continued from page 176)

ment analyst and accomplishes this while sustaining an unusually high level of reader interest. No student can reasonably complain about the readability of this book despite its—to the student—formidable title. The author has achieved economy of words without the loss of clarity.

A discussion of the advantages of comparative reports over single-year statements introduces the subject. The underlying theme of the book is that, because of the hybrid nature of the statements, (representing as they do a combination of recorded facts, accounting conventions, postulates and personal judgments), no statement for a single year can be as significant as one covering a series of years. The changes made evident by an inspection of balance sheets of successive periods may reveal information as critical as that reflected in any one statement. Furthermore, the rate of change is as important as the absolute change, and this point leads to the introduction of ratios, the one hundred per cent balance sheet, horizontal and vertical analyses of balance sheets, and, finally, the Statement Accounting for Variation In Capital.

The Funds Statement, for which the author introduces a simplified type of worksheet, is covered well. Several alternative statement forms are illustrated. An adaptation of the Funds Statement, "The Statement Accounting For Variation In Cash," is introduced in this text. This statement is interesting in its own right, and, when contrasted to the conventional funds statement, should help the student to understand better the procedures of preparing the latter report.

The techniques of analysis are then applied to the Income Statement with the resulting exposition of the function of the one hundred per cent income statement, the use of horizontal analyses of a series of income statements, the construction of statements accounting for variation in net income and in gross margin, and the computation of break-even point analysis.

The various ratios commonly used by analysts are well illustrated. These include, among others, the current ratio, acid test, capital to liabilities, capital to noncurrent assets, cost of goods sold to average inventory, gross margin to sales, net income to sales, and net income to capital. Professor Myer glosses over several ratios given emphasis in other texts, but this treatment appears to be deliberate. He warns against over-reliance on ratios and the formulation of illogical ratios.

A separate chapter is devoted to four illustrative cases which exemplify the application to concrete situations of the analytical techniques developed in the text. The cases show how the use of trend ratios complements the employment of the structural ratios. The cases are good but hypothetical. The inclusion of at least one analysis of the

(Continued on page 178)

## BOOK REVIEWS

(Continued from page 177)

reports of an actual and well-known company would have been extremely interesting.

The author holds no brief for standard ratios, and does not consider it necessary to include in the text some of those made available by credit institutions. He does describe the kinds of standard ratios which have been formulated and indicates some sound reasons why the usefulness of such measures is very limited at the present time. In this regard, Professor Myer takes a position opposed to that assumed by Mr. Roy A. Foulke in the latter's writings on the subject.

Appendices include a pertinent extract from Regulation S-X of the Securities Exchange Commission on the Form and Content of Financial Statements and also the 1948 revision of the American Accounting Association's "Accounting Concepts Underlying Corporate Financial Statements."

The text is accompanied by a separately bound set of laboratory problems and questions designed for use in one-semester courses in Financial Statement Analysis.

PHILIP M. PIAKER

Harpur College
State University of New York
Endicott, N. Y.

### 1953 Farmers Income Tax

By Samuel M. Monatt. COMMERCE CLEARING HOUSE, INC., Chicago, Ill., and New York, N. Y., 1953. Pages: 175, paper covers; $3.00.

This is the sixth edition of this pioneer handbook on farm tax problems. Like its predecessors, it continues to make thoroughly understandable the peculiarities involved in preparing and filing a farm income tax return. A handy check list of important things to remember is also included, as well as a detailed topical index.

### Managing Your Money

By J. K. Lasser and Sylvia F. Porter. HENRY HOLT AND COMPANY, New York, N. Y., 1953. Pages: xiii + 430; $4.95.

This new volume endeavors to tell you everything you need to know about money matters including pertinent facts about home financing, loans, investment, insurance, social security, hospitalization plans, budgets, and every other category of personal finance. The advice is geared to the size of your income, and accordingly will enable you to make the most of your present income. The authors are well-known writers in the field of finance.

(Continued on page 180)

## BUSINESS AND PERSONNEL OPPORTUNITIES

| | |
|---|---|
| **Help Wanted:** | **20¢ a word, minimum $5.00.** |
| **Situations Wanted:** | **10¢ a word, minimum $2.00.** |
| **Business Opportunities:** | **15¢ a word, minimum $3.00.** |

**Box number, if used, counts as three words.**
**Closing Date—15th of month *preceding* date of publication.**

### BUSINESS OPPORTUNITIES

Mail and Telephone Service: Desk provided for interviewing. $6.00 per month. Directory Listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Are you in need of Furnished Office, Desk or Mail and Phone? All available with complete service—use of conference and reception rooms. Stenographic service at a nominal fee. Mactell Service Co., 489 Fifth Ave. (42nd St.), New York City. MU 2-2492.

**Statistical Typewriting**

Reports, mimeographing, personalized letters, Vari-typing, IBM typesetting. M. E. Gitsham, 140 East 45th Street, N. Y. 17 Grand Central area. MU 2-6891-2; LE 2-2177.

**Calculating Service**

Inventories computed, sales analysis, etc. Statistical experience. Special service to C.P.A.'s. Formerly with U. S. General Accounting Office. Verna Crawford, 565 Fifth Avenue, ELdorado 5-0280.

New York City and Vicinity—Established C.P.A. desires to purchase or service small practice or individual accounts. Will consider partnership. Box 555, New York C.P.A.

New York City—Medium CPA firm has opening for CPA-Attorney qualified to supervise tax practice. Will consider participating arrangement. Box 556, New York C.P.A.

**Collection Specialists in 48 States**

Commercial and Installment Accounts. No Collection—No Charge—Bonded. 220 W. 42nd, Eastern Credit Company, LOngacre 4-2495.

### SITUATIONS WANTED

**Statistical Typing**

Financial reports, tax returns, expertly typed on latest IBM electric. Ten years certified experience. Reasonable—confidential. JUdson 6-3879.

Tax Law position desired. LL.B. Harvard June '53, B.B.A. CCNY '50, 3/4 CPA, age 24, single, draft exempt. Arne Siegel, 217 Ames Hall, Harvard Law, Cambridge 38, Mass.

## Book Reviews

(Continued from page 178)

### Corporate Taxation and Procedure in Pennsylvania (Second Edition)

By Leighton P. Stradley and I. H. Krekstein. COMMERCE CLEARING HOUSE, INC., Chicago, Ill. and New York, N. Y., 1952. Pages: vi + 544; $7.50.

This is a new second edition of a helpful handbook which would seem to answer fully the need for a readable, informative text incorporating the extensive changes concerning corporations made in the Pennsylvania tax system since 1935.

For in this new second edition the authors take up not only such changes as the new Corporation Income Tax Law of 1951, and the 1951 amendments providing for the filing of tentative Corporate Net Income and Corporation Income Tax Returns in 1953 and other late developments, but also the ins-and-outs of Pennsylvania corporate taxation involved in domestic and foreign bonus, capital stock-domestic corporations, franchise-foreign corporations, corporate loans—together with the procedure in settlement and collection of these taxes.

The background and standing of the authors attest to the practical value of the work.

### Executive Pay Plans (1952-1953)

By William J. Casey and J. K. Lasser. BUSINESS REPORTS, INC., New York, N. Y., 1953. Pages: 160; $12.50.

This is a valuable new study by two nationally-known tax men. It explains new techniques developed by our largest companies to reward executives through stock options, deferred pay and pension plans, family management benefits, expense arrangements, the use of insurance, and other executive benefits.

It demonstrates how the executive can acquire capital and provide future security for himself and his family. Also, how a company can attract and retain executive talent and experience.

### Behind the Scenes of Business (Revised Edition 1952)

By Roy A. Foulke. DUN & BRADSTREET, INC., New York, N. Y., 1953. Pages: 194.

This, the 1952 edition of this work, has been completely revised, rewritten and enlarged to meet the present economic situation. All tables have been brought up to date, and new cases and current business problems and situations have been added.

A new chapter on the "Relativity of the Moral Hazard" has been added. This chapter discusses the influence of a progressively adverse financal condition of a business upon the moral stamina of individuals in management, and how in times of great pressure, it may occasionally result in a breakdown of character.

(Continued on page 181)

## Book Reviews

(Continued from page 180)

The Appendix contains the up-to-date five-year averages of the Fourteen Important Ratios for 70 lines of business activity which have become widely used over the years since they first appeared in 1932. These financial signposts have been subject to minor changes, largely influenced by the problems of the war and post-war years. The Appendix also contains the failure records for the country, and the terms of sale most frequently used in 87 lines of industry and commerce.

### The New General Ledger

By Oscar Mautner and Joseph A. Mauriello. Industrial Methods Corporation, New York, N. Y., 1951. Pages: x + 177; $3.50 plus 20¢ mailing charge (3% sales tax in New York City).

In their Preface the authors indicate that, in their opinion, the present-day "general ledger has a basic, irremediable defect. It separates the complementaries originally set up in the journals, and buries all financial facts in composite debit and credit money columns. Relationships between accounts are completely concealed, making impossible an analysis of operations by types of transactions. This shortcoming is a serious one, for transaction-types represent the casual factors responsible for financial condition and operating results. The needed information on transactions is presently obtained not from the ledger but from a recasting of the entries in the journals. This procedure entails a needless retracing and duplication of bookkeeping steps."

In order to overcome these stated deficiencies, the authors have developed this new ledger plan which, they claim, "automatically produces a complete all-revealing analysis of operations and at the same time establishes a reciprocal control by individual accounts."

This work illustrates the method of operating their New General Ledger and points out the numerous uses in auditing and in private accounting which they believe will benefit management through its use.

THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

*The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.*

VOL. XXIII | *March* • *1953* | No. 3

# Significant Tax Decisions of 1952

*By* JACK SCHLOSSER, C.P.A.

ASIDE from the problems of time and space the most vexing hurdle confronting the writer on this assignment was the question of selectivity. In attempting to overcome this problem, an extremely wide range of tax decisions issued during 1952 has been catalogued, their substance briefly indicated and their significance suggested where this was not self-evident. As in past years, the interests of the tax practitioner conducting the average accounting practice have been kept uppermost in mind. If this article succeeds in suggesting a trend in decisions on any subject in the field of taxation; if it serves during the year as a quick means of resolving a tax dispute with a tax examiner; if it sets anyone on the track of a series of cases resolving a troublesome issue; then, in great measure, the purpose of this article will have been accomplished.

JACK SCHLOSSER, C.P.A., is a member of our Society and Chairman of its Committee on State Taxation.

He was graduated from The City College (New York) School of Business and Civic Administration in June, 1939, with the degree of B.B.A.

Mr. Schlosser is a partner in the firm of Eisner and Lubin, CPA's.

## Supreme Court Decisions

During 1952 several knotty, if not far-reaching, tax controversies were resolved by the Supreme Court. Chronologically the court ruled as follows:

a) Payments by opticians to prescribing doctors of a percentage of the sales price of eyeglasses were held deductible as ordinary and necessary business expenses, where their payment reflected an established and widespread industry practice. The Commissioner's effort to maintain that these expenditures frustrated a sharply defined public policy and hence were not deductible, was set aside by five out of eight presiding justices who expressed "no approval of the business ethics or public policy involved" but who stated that unless the "policies frustrated were national or state policies evidenced by some governmental declaration of them", the Commissioner's view could not be sustained. This decision is significant to tax practitioners not for the narrow set of facts reviewed but for its clear definition of "public policy."

(*Thomas B. Lilly* v. *Commissioner,* 72 S. Ct. 497, March 10, 1952.)

Later in the year the Tax Court ruled that payments made to a purchasing agent of one of taxpayer's customers of a percentage for each item purchased were "bribes" and not a "standard business practice." They

were hence distinguishable from the *Lilly* payments and were deemed non-deductible.

(*Estate of R. N. Lashells* v. *Commissioner*, Tax Court Memo Decision, March 28, 1952; appeal pending.)

b) Attorneys' fees paid for contesting a proposed gift tax deficiency were ruled non-deductible. Taxpayer had maintained that these expenses were connected with the production or collection of income and/or the management, conservation or maintenance of property. It was noted that the deficiency proposed amounted to $150,000 and that its payment would have seriously impaired taxpayer's capital and his income therefrom.

The Court was unimpressed with this line of argument. The deductibility of the fees depended upon the "nature of the activities to which they relate." Gifts could not be deemed to be made for the maintenance of capital or for the production of income and hence fees incurred because of them could not be deductible.

(*Joseph T. Lykes* v. *United States*, 72 S. Ct. 585, March 24, 1952.)

In a later decision the Tax Court permitted a deduction for a lawyer's fee resulting from the negotiation of an agreement for alimony payments to be made in installments rather than a lump sum. The single payment would have disrupted the taxpayer husband's property holdings. The court felt that the *Lykes* ruling could be distinguished because it was concerned with property which had been given away, whereas, in the instant case, the taxpayer was concerned with conserving property which had not yet been given away. To the writer the decision seems equitable but the logic behind it would appear to be a bit strained.

(*Arthur B. Baer* v. *Commissioner*, CCA-8, May 7, 1952.)

c) Money extorted from a victim with his consent, induced by threats of violence, was held to be taxable income notwithstanding its illegality.

(*James Rutkin* v. *United States*, 72 S. Ct. 571, March 24, 1952.)

d) In another decision the court ruled that a contest prize won by a composer in a musical contest was not a gift but constituted taxable income. This decision was predicated upon the following:

1) Payment of a prize to a contest winner constitutes the discharge of a contractual obligation.
2) The acceptance of the sponsor's offer by the contestant creates an enforceable contract.
3) The discharge of a legal obligation or a payment pursuant to a contract cannot be deemed a gift.

(*Leroy J. Robertson* v. *United States*, 72 S. Ct. 994, June 2, 1952.)

This view was followed in a subsequent case involving a contest sponsored by a foundation awarding prizes for papers dealing with the subject of arc welding.

(*Hofferbert* v. *Amirikian*, CCA-4, June 16, 1952.)

A secondary issue in the *Robertson* case was resolved when the court determined that the period of pro-ration for the purposes of Section 107(b), dealing with income from artistic compositions, is the 36-month period ending with the close of the current taxable year and not the 36-month period ending with the completion of the composition. This treatment contrasts somewhat with the application of Section 107(a) dealing with compensation for services rendered over a period of 36 months or more.

The foregoing treatment of Section 107(b) income was followed in the case of *Edwin Harvey Blum* v. *Commissioner* (Tax Court Memo Decision, June 18, 1952) which also ruled that a writer may include in the qualification period, not only the period of actual writing, but also the time spent in research and planning.

e) Another issue which was the subject of much litigation during the years

1950 to 1952 was finally settled by the Supreme Court when it ruled that corporate expenses paid by a stockholder after liquidation gave rise to a capital loss and not a fully deductible ordinary loss.

(*F. Donald Arrowswmith, et al.* v. *Commissioner,* United States Supreme Court #51, November 10, 1952.)

**Section 45, 129, etc.**

In this era of ascending individual and corporate rates, excess profits and surtax exemptions, etc., the judicious dispersal of income among related taxpayers is becoming a major source of tax savings. That the Commissioner is aware of this factor is evident from the ever-increasing number of cases on this issue plaguing the courts.

In the following cases all or a part of a corporation's activities were taken over by an individual proprietorship or partnership composed of corporate stockholders or persons related to them and the Commissioner's efforts to reallocate or disregard under Section 45 were upset:

*Palm Beach Aero Corporation,* 17 TC 1169, January 15, 1952; *Robert Matherne et al.* v. *Scofield,* U. S. District Court, Western District of Texas, July 10, 1952; *Nicholson-Jones Motor Co.* v. *Campbell,* U. S. District Court, Northern District of Texas, February 15, 1952; *Motors Securities Company, Inc.,* Tax Court Memo Decision, March 30, 1952; *Seminole Rock and Sand Company,* 19 TC—No. 36, November 18, 1952.

It is well to note that the utilization of a proprietorship or partnership for the foregoing purpose carries with it a double danger. Not only may Section 45 be invoked, taxing all or part of the transferred income back to the originating corporation, but the same income may be taxed to the stockholders as a dividend.

(*Harry Byers* v. *Commissioner,* CCA-8, October 29, 1952; appeal pending.)

In addition care must be taken to avoid converting the corporation into a personal holding company.

(*Western Transmission Corp.,* 18 TC—No. 100, July 30, 1952.)

The foregoing may be avoided by syphoning income from one corporation to another. This was successfully accomplished in the case of *Commissioner* v. *Chelsea Products, Incorporated* (CCA-3, June 24, 1952, nonacq.; appeal pending). Here the sales activities of an existing corporation were taken over by three sales corporations owned by the stockholders. The business purpose for the subdivision was the desire to minimize tort liability from use of taxpayer's products. The court not only rejected the Commissioner's attempt to adjust under Section 45 but also questioned the applicability of Section 129.

Where the distribution of income among related corporations is arbitrary and capricious; where the books and records of all of the corporations were kept in such a way that the net profit could be manipulated as the owners saw fit; where there was no motive to the reorganization other than to divert income from the petitioner, the entire income of each of the newly organized corporations was taxed back to the original company.

(*Advance Machinery Exchange, Inc.* v. *Commissioner,* CCA-2, May 12, 1952.)

The court also ruled that the Commissioner could allocate *all* of the income of an affected entity under Section 45 and was not restricted to a partial adjustment. Finally the court determined that the invested capital of the non-recognized corporations need not be transferred to the corporation taxed with their income.

A popular device for spreading income is by way of rent arrangements between related parties. A review of these cases should, therefore, be of interest:

a) Where a corporation rented property from a corporation controlled by its own stockholders, an arbitrary rent increase from $100.00 to $300.00 a month was disallowed.

(*The Pennock Plantation, Inc.,* Tax Court Memo Decision, October 8, 1951.)

b) Rent paid by a corporation to a partnership composed of its stockholders after a sale and lease-back, was ruled non-deductible because the corporation retained such control over the property as to be deemed the true owner.

(*Shaffer Terminals, Inc.* v. *Commissioner,* CCA-9, March 3, 1952.)

c) Similarly the leasing of a theatre by a corporation to the wife of its principal stockholder at a rent geared to yield her a substantial profit was not recognized by the court. Not only was the wife's net income taxed back to the corporation but remained taxable to her as a dividend even though her husband was the stockholder.

(*58th Street Plaza Theatre, Inc.* v. *Commissioner,* CCA-2, March 18, 1952.)

d) Increases in rent extending from a corporation to a family trust or from a husband to a wife were disallowed.

(*Consolidated Apparel Co.,* 17 TC 1570, March 21, 1952; *Roland F. Place* v. *Commissioner,* CCA-6, October 21, 1952; appeal pending.)

A late 1952 decision offers much encouragement to practitioners who have attempted or who are contemplating the use of "loss" corporations. The courts have apparently indicated that Section 129 does not apply where the loss originates with the corporation using it. Thus if the stock of a "loss" corporation is acquired and a profitable business is inserted therein either by purchase or merger, the net operating loss and/or unused credit originating with the prior unprofitable operations may be used against the new income.

(*Wage, Inc.,* 19 TC—No. 35, November 18, 1952.)

### Form v. Substance

The courts continue to joust with taxpayers in their efforts to cast transactions in the form best calculated to give rise to favorable tax consequences. The following are the more outstanding examples of this struggle:

A written sales agreement between two unrelated parties and the book entries of the taxpayer were brushed aside by the court as mere form which could not be deemed decisive where examination of all the facts and circumstances gave rise to a different interpretation. The written contract specified the individual sales price of the fixed assets and inventory being conveyed. The Commissioner reallocated the price between the two classes of assets on a more realistic basis and his findings were approved by the court.

(*Giulio Particelli,* Tax Court Memo Decision, February 20, 1952.)

A lease with option to purchase was held to represent, in fact, a sale and the proceeds therefrom were taxable as such

(*L. M. Graves,* Tax Court Memo Decision, May 14, 1952; *W. H. Hughes,* Tax Court Memo Decision, July 31, 1952; *Joe W. Scales,* 18 TC—No. 153, September 30, 1952.)

On the other hand, the Tax Court was reprimanded for treating a lease as a purchase contract when its decision had been influenced primarily by application of the economic test laid down in its *Chicago Stoker* opinion. In the latter case it had been held that a lease with option to buy was, in fact, a purchase contract when the "rental" payments were large enough to exceed the depreciation and value of the property, thus giving the "lessee" an equity in the property. In the instant case, the Fifth Circuit ruled that the intent of the parties was controlling; that tax consequences had not been considered; that the contract as drawn reflected their true intent; that the option terms were not unreasonable when made; that the conduct of the parties was consistent with a lease. This was one instance where "form" and "substance" were deemed to coincide.

(*H. T. Benton* v. *Commissioner,* CCA-5, June 20, 1952.)

Where taxpayer was obliged to purchase stock of American Distilling Company in order to obtain a whiskey dividend, the loss on the sale of the stock was not a capital loss but was deductible as part of the cost of goods sold (*Gordon Scott Hogg* v. *Allen,* United States District Court, Georgia, May 5, 1952). The Tax Court arrived at a contrary conclusion on virtually the same set of facts in the case of *Charles A. Clark* (18 TC—No. 106, August 6, 1952), but later reversed itself in the case of *Western Wine and Liquor Co.* (18 TC—No. 137, September 24, 1952). The Tax Court also ruled that where a retail lumber dealer's payment for stock of a logging company was accompanied by a simultaneous option to sell said stock at a substantially lower price, the resultant loss was, in reality, an overceiling payment for lumber and properly includible in cost of goods sold.

(*W. M. Young Company,* Tax Court Memo Decision, August 14, 1952.)

The distribution by a corporation of a valuable patent as a dividend followed by a lease-back was not recognized. Consequently, the deduction for royalties under this patent was disallowed.

(*Stearns Magnetic Manufacturing Company,* Tax Court Memo Decision, May 19, 1952.)

### Tax-Free Exchanges, etc.

Cases involving judicial interpretation of the tax-free exchange and reorganization provisions of the Code are always of special interest to most practitioners. Accordingly, a few of the more significant 1952 decisions on these and other closely-related issues are hereinbelow outlined:

a) Corporation A transferred assets including some government bonds to a newly-formed Corporation B in exchange for all of its stock. The former then distributed this stock to its stockholders in exchange for half of its own stock. This was held to be a tax-free exchange under Section 112 (b)(3). A delay between the first and second steps was ignored and the whole operation was treated as one plan of reorganization. The business motive was to separate a risky Texas oil venture from the rest of the principal corporation's business activities which were in California.

(*Chester E. Spangler,* 18 TC—No. 123, September 10, 1952.)

b) Corporation A was engaged in the pharmaceutical business but also owned some ranch property not germane to its principal activity. It conveyed the property to a newly-formed subsidiary for all of its stock. It then distributed its own new stock plus the stock of the subsidiary to its stockholders upon surrender of its old stock. This too was held a tax-free reorganization and not a distribution equivalent to a dividend under Section 115(g).

(*Rufus Riddlesbarger* v. *Commissioner,* CCA-7, November 17, 1952.)

c) Corporation A transferred all of its assets to Corporation B in exchange for stock and warrants. Thereafter, and as contemplated in the original plan, Corporation B sold additional stock to the public to raise additional capital. The actual exchange was held to constitute a tax-free exchange under Section 112(g)(1)(c) since Corporation A was "in control" of Corporation B "immediately after the transfer." The date of completion of the sale of the additional stock to the public was not the decisive date for determining "control" notwithstanding its contemplation at the time of the original conveyance.

(*Scientific Instrument Company,* 17 TC 1253, January 31, 1952.)

d) Corporation A transferred assets to a newly-formed Corporation B for stock. Simultaneously stock of B was issued to Corporation C for cash. The original incorporation of B was a tax-free exchange under Section 112(b)(5) whether considered before or after the investment of cash by C.

(*May Broadcasting Company* v. *United States,* United States District Court, Southern District of Iowa, March 15, 1952; appeal pending.)

e) In two instances the substitution of debenture bonds by a corporation for its outstanding preferred stock was held to constitute a tax-free recapitalization and not a dividend distribution. The courts conceded that tax savings was a principal motive yet approved the exchange because of the other practical corporate ends accomplished.

(*Willis E. Penfield* v. *Davis,* U. S. District Court, Northern District of Alabama, May 7, 1952, appeal pending; *Daisy Seide et al.,* 18 TC—No. 60, June 11, 1952.)

f) Normally a stock dividend of preferred on common would constitute a non-taxable dividend. Where the stockholders, however, had made a prior commitment to sell said preferred stock, the court deemed it a taxable dividend.

(*C. P. Chamberlin,* 18 TC—No. 23, April 30, 1952; appeal pending.)

g) Where a wholly-owned subsidiary is liquidated under Section 112 (b)(6) the subsidiary may be deemed to have incurred taxable income where:

1) Its assets have appreciated in value and
2) It was indebted to parent corporation prior to liquidation.

Whether this ruling has wider application than the limited situation specifically noted is a question which is troubling many practitioners.

(*I. T. 4109;* 1952—13968.)

### Stock Redemptions

The problem of withdrawing cash from a corporation without resulting in a tax thereon as a divdend has intrigued taxpayers and the courts alike for some time without conclusive results except to indicate a clear area of risk. Some of the 1952 decisions on this point follow:

(1) Taxpayer owned virtually all of the stock of a corporation to which he was indebted for $120,000. In order to secure an improved Dun & Bradstreet rating for the corporation, such indebtedness had to be reduced by about 50 per cent. Accordingly, 600 shares of preferred stock of the corporation was turned over to the corporation at $100 per share and taxpayer reduced his debt by $60,000 (the improvement to the corporate financial setup seems obscure to the writer). It was held under all the facts that the transaction did not occur at such a time and in such a manner as to be essentially equivalent to a taxable dividend.

(*Isaac C. Eberly,* Tax Court Memo Decision, December 13, 1951.)

(2) Where one stockholder agreed to buy out the other and used corporate funds to do so, it was held to represent a taxable dividend to the remaining stockholder and not a partial liquidation of the retiring stockholder's interest. This was strictly a situation resulting from a failure to consider the tax effects of the transaction before being consummated.

(*Frank R. Holloway,* Tax Court Memo Decision, December 12, 1951; appeal pending.)

(3) Taxpayers were stockholders of a tractor distributing corporation. The corporation had lost its Caterpillar Tractor distributorship and took on the Allis-Chalmers line. As a result, the need for cash capital declined. Taxpayers were also making arrangements to sell the business. Consequently, 80 out of its 500 outstanding shares were redeemed. The Court found that the corporation had acted prudently and with a business purpose, hence the redemption was not the equivalent of a dividend distribution.

(*Clarence R. O'Brian,* Tax Court Memo Decision, November 30, 1951.)

(4) The preferred stock of a corporation had been issued upon incorporation to provide supplemental funds equivalent to capital loans. When it was determined that these funds were not required in the business they were

returned. As such the stock redemption was not the equivalent of a dividend.

(*G. E. Nicholson*, 17 TC 1399, February 28, 1952; non-acq.; appeal pending.)

(5) Corporation owned assets which it could not exploit or develop because of risk factors implicit therein. The assets were distributed in exchange for a portion of its own stock. It was held that business purposes and motives dictated the distribution; the redeemed stock had been originally issued for consideration and for a legitimate business reason; the corporation did not consider itself as being in a position to distribute a dividend. The Court ruled that no dividend resulted from this distribution.

(*John L. Sullivan*, 17 TC 1420, February 29, 1952; appeal pending.)

(6) Petitioner owning 50% of the stock of a corporation inherited the remaining 50% from the estate of a brother thereby becoming the owner of all the corporate stock. The deceased's stock was transferred to the taxpayer. Thereupon, the corporation redeemed the inherited stock. The Court ruled that it was the estate's and not the taxpayer's stock that was being retired; that the corporation's assets were being reduced proportionately; that the stock retirement was not the equivalent of a dividend distribution.

(*John T. Roberts*, 17 TC 1415, February 29, 1952; non-acq.; appeal pending.)

(7) The sole owner of a corporation's stock desired to sell her stock to some outsiders. The latter did not want to take over the corporation with its large surplus for obvious tax reasons. Consequently, only 47 out of 108 shares were sold to the outside interests. Taxpayer then sold the remaining 61 shares to the corporation thereby terminating her interest in the corporation. The amount paid for her remaining stock was approximately equal to the corporate surplus. The court ruled this latter sale to represent the distribution of a dividend, a decision which the writer disagrees with vehemently.

(*Fern R. Zenz* v. *Quinlivan*, U. S. District Court, Northern District of Ohio, June 27, 1952.)

(8) In a transaction which had the same motivation as the *Zenz* exchange, a corporation redeemed a portion of its outstanding stock and issued some mortgage bonds in exchange therefor. The remaining stock was then sold to the taxpayer and his associates. During the subsequent years corporate funds were used to pay interest and principal on said bonds. The Commissioner attempted to tax these payments to the taxpayer as a dividend on the grounds that the bonds were, in reality, additional purchase price on the stock and hence represented the liability of the taxpayer and not that of the corporation. This is a reversed position from the *Zenz* case on the part of the Commissioner and his views were rejected. It is the writer's opinion that he might have been successful if he had attempted to tax the former stockholders in the year the bonds were distributed.

(*Ray Edenfield*, 19 TC—No. 3, October 10, 1952.)

While some of the foregoing cases wherein the taxpayer was successful should be helpful to practitioners already faced with the problem, it is the writer's opinion that they should not be the basis for designing equivalent transactions without an advance ruling by the Commissioner. It is recognized that this may be difficult if not impossible to secure.

**Partnerships**

That the sale of a partnership interest represents the sale of a capital asset has been well established by the courts and accepted by the Commissioner. Nevertheless auxiliary aspects of this problem still found its way into the courts during 1952.

Where a partner sold out his interest in a partnership after the beginning of its fiscal year, the portion of his sales

proceeds which represents his share of the currently undistributed net profits is taxable as ordinary income. The holding period of his partnership interest must be measured from the date of its acquisition and not from the date or dates of acquisition by the partnership of the specific partnership assets.

(*Hamilton A. Gray,* Tax Court Memo Decision, January 11, 1952.)

The gain on the sale of a partnership interest is a capital gain even though transferred by one partner to the other in exchange for a continued interest in some of the profits from partnership operations. The tax implications of this decision to the remaining or purchasing partner should be particularly noted by practitioners.

(*U. S.* v. *Andy and Mary Jones,* CCA-10, February 19, 1952.)

Where a partnership held installment obligations at the time of a sale of an interest therein, the retiring partner's share of the unrealized profit is taxable to him as ordinary income rather than as capital gain.

(*Rhett W. Woody,* 19 TC—No. 46, November 28, 1952.)

The partnership agreement of an accounting firm provided that upon the death, retirement or withdrawal of a partner, his interest would be transferred to the continuing partners but that the partnership would not be dissolved. Thereupon there would be paid to said retiring partner or his estate the amount of his capital account and his share of the current year's income. In addition, upon death or retirement, there was to be paid an amount equal to three years' earnings over a six year period. Payments made pursuant to this latter provision were held to be distributions of income to the retired partner and deductible by the continuing partners since no sale of a partnership interest was intended. This case should be studied along with the *Jones* decision previously described to determine how a partnership termination should be designed.

(*Carol F. Hall,* 19 TC, No. 57, December 11, 1952; *Charles R. Whitworth,* Tax Court Memo Decision, December 12, 1952; *Francis J. Clowes,* Tax Court Memo Decision, December 12, 1952.)

On February 19, 1952, the Commissioner issued *Mimeograph 6767* setting forth a clarification of his views on family partnerships where capital was a material income-producing factor and for years beginning prior to January 1, 1951. This ruling should be most helpful in settling pending partnership tax disputes and might even form the basis for claims for refund for open years.

Operating jointly-owned real property does not constitute a partnership or joint venture. It would appear that each co-owner may report his share of income from the property in his own return; a partnership return would not be required. A sale of his interest by a participant is not a sale of a partnership interest but a sale of a share of property.

(*Almy Gilford,* Tax Court Memo Decision, February 27, 1952; appeal pending.)

The lumping of more than twelve months' partnership income in a decedent partner's final return had been the subject of a series of cases wherein the Third, Fifth and Eighth Circuits in prior years had ruled against such pyramiding, where both the state law and partnership agreement provided for the partnership to continue after the death of a partner. The Tax Court apparently was content to follow these findings but was upset by the Second Circuit in 1952. There it was ruled that death terminates a partnership, thereby creating another short taxable year insofar as the decedent was concerned. This dispute may have to be resolved by the Supreme Court.

(*Commissioner* v. *Estate of Isidore Waldman,* CCA-2, April 14, 1952.)

### Capital Gains or Losses

The Tax Court's 1951 finding that an amount received by a tenant from his landlord for an early surrender of the premises represented a capital gain, was sustained on appeal.

(*Commissioner* v. *Isidore Golonsky,* CCA-3, November 28, 1952.)

Similarly the payment received by a tenant from his landlord for relinquishing a restriction in the lease results in a capital gain.

(*Louis W. Roy,* 18 TC 438, May 29, 1952; appeal pending.)

Where individuals formed and built up businesses in corporate or partnership forms followed by their sale after 6 months, it was held that the resultant income was capital gain and not disguised compensation for services.

(*W. P. Melton,* Tax Court Memo Division, February 13, 1952.)

A surrender of an exclusive sales agency to the issuing company was held to represent a sale resulting in a capital gain.

(*Starr Bros., Inc.,* 18 TC 149, April 30, 1952; appeal pending.)

Similarly a sale of a general agency contract with an insurance company was deemed to result in a capital gain.

(*C. A. Sammons* v. *Dunlap,* U. S. District Court, Northern District of Texas, June 21, 1952.)

However, the sale by a theatre booking agency of an artist's personal service contract did not achieve this desired result.

(*General Artists Corporation,* 17 TC 1517, March 18, 1952; appeal pending.)

The importance of the wording of a sales contract covering the sale of a business is stressed in the decision of *Ethyl M. Cox, et al.* (17 TC 1287, February 11, 1952). A gain on the sale of good will was held to be a capital gain; if it had been attributable to a covenant not to compete, ordinary income would have resulted.

Where a corporate officer acquired depreciable property and inventory from a corporation by purchase and resold same at a profit, the resultant income was taxed as a capital gain. The court determined that the assets in question "were not held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

(*L. M. Graves,* Tax Court Memo Decision, May 14, 1952.)

The Tax Court persists in its effort to hold a corporation free of tax on sales of its own capital stock where it had not dealt in its own shares as it might have dealt in the shares of another corporation. In this case the stock had been purchased by the corporation as a convenience to its employees. In 1946 some of the stock was sold to qualify a director. Later in the same year the rest of the stock was sold to raise capital for expansion purposes.

(*The Landers Corporation,* Tax Court Memo Decision, June 9, 1952; appeal pending.)

**Compensation for Services**

a) Where the taxpayer rendered professional services and, in consideration therefor, a payment was made directly to a religious organization, said payment was deemed to constitute income to the taxpayer for services rendered. Presumably he would be entitled to a deduction for charitable contributions provided the payee was a properly qualified organization and subject to the percentage limitation on such deductions.

(*George C. Johnson,* Tax Court Memo Decision, January 17, 1952; appeal pending.)

b) An amount received from an employer toward the purchase of a residence was demed taxable income even though part of a moving program, and even though employee was being forced to move from a low to a high rent area.

(*Joseph A. Le Grand* v. *United States,* U. S. District Court, Northern District of Ohio, June 20, 1952; *Jesse S. Rinehart,* 18 TC—No. 79, June 26, 1952.)

c) Payment of medical expense of an employee by an employer is deductible as *additional compensation* and presumably would be taxable as such to the recipient.

(*Mary Sachs,* Tax Court Memo Decision, August 20, 1952.)

If, however, these payments are made under a company plan which is the equivalent of a health insurance policy, the proceeds would be exempt to the employee under Section 22(b)(5) of the Code.

(*Arnold W. Epmeier* v. *United States,* CCA-7, October 29, 1952.)

d) Taxpayer received a commission check for 1946 services on December 31, 1946, but after banking hours. It was held that taxpayer realized his income upon receipt of the check in 1946. Payment by check is conditional payment subject to the condition that the check will be honored upon presentation; once such presentation is successfully made payment relates back to the date of delivery.

(*Charles F. Kahler,* 18 TC—No. 3, April 4, 1952.)

Absence of book entries will not defeat constructive receipt to a stockholder-employee in the year the resolution of payment was adopted and funds were available.

(*James J. Cooney,* 18 TC—No. 111, August 20, 1952.)

e) Rent-free use of an apartment by a stockholder-employee was not deemed additional income when said use was furnished for the convenience of the employer-corporation which operated a hotel.

(*C. Walter McCarty,* U. S. District Court, Indiana, May 22, 1952.)

f) Payments to taxpayer's wife, presumably on account of purchase of stock from her, were taxable to taxpayer as ordinary income when deemed related to future services to be rendered by him.

(*Foster G. Beamsley,* 18 TC—No. 124, September 12, 1952; appeal pending.)

g) Several decisions issued during 1952 affected tax calculations under Section 107, dealing with compensation received for services rendered over a long-term period. During 1951 it was established that a partner can share in the benefits of this section with regard to a fee received by his firm even though he was not a partner for the full period of the services in question. In 1952 the court extended this privilege to an attorney who was consulted on a case and who shared in the fee. It was held that he shared the same privileges as a partner by virtue of his being deemed a joint-venturer in the case. It did not matter that his services had been of short duration as long as the other parties thereto had worked on the case for 36 months or more.

(*Hubert Van Hook* v. *U. S.*, U. S. District Court, Northern District of Illinois, August 8, 1952; appeal pending.)

Any doubts as to whether a Section 107 recalculation of prior years' taxes would involve the medical expense and contribution deductions of those prior years was eliminated by a government ruling to that effect. The rule will not affect years ended prior to January 1, 1950.

(I. R. Mim. No. 43; September 30, 1952.)

A trustee was not permitted to split his commission between income and corpus and apply Section 107 to each separately.

(*Irving B. Kingsford* v. *Manning,* U. S. District Court, New Jersey, November 24, 1952.)

In a decision which was rather startling to this writer, it was held that where a husband and wife filed a joint return that included Section 107 long-term compensation received by the husband, the tax is calculated by allocating one-half of such compensation to each spouse and then pro-rating each half separately over the period in which it was earned.

(*R. E. Lee Marshall* v. *Hofferbert,* U. S. District Court, Maryland, May 23, 1952.)

h) Where an individual contributed compensation earned by himself to a partnership, said income remained taxable to him and did not become

partnership income allocable for tax purposes under the company agreement.

(*W. B. Mayes et al.* v. *U. S.*, U. S. District Court, Eastern District of Oklahoma, August 5, 1952.)

i) High bracket taxpayers and their representatives should be interested in a Tax Court decision which held that retired insurance salesmen would be taxed on renewal commissions when received under a special retirement election and not when earned under the terms of the original insurance contracts. Upon retirement the salesmen were entitled to collect commissions on renewals and could receive same as premiums were paid to the company. In the alternative an irrevocable election could be made to take them in installments over a period of 180 months. Petitioners made an election to take $1,000 a month for a period not to exceed 18 months. Their taxable income was restricted to the $1,000 a month notwithstanding the fact that their accounts were credited with more on the bases of commissions actually earned.

(*James F. Oates et al.*, 18 TC—No. 69, June 20, 1952; appeal pending.)

j) The exercise of a stock option by an employee was held not to result in taxable income. This option was not given as compensation but for the purpose of granting a proprietary interest in the employer-corporation. The principal factor leading to this conclusion was the fact that the option agreement survived termination of employment.

(*Donald B. Bradner*, Tax Court Memo Decision, June 4, 1952; appeal pending.) (A similar conclusion was reached in the case of *Martin L. Strauss II*, Tax Court Memo Decision, July 30, 1952; appeal pending.)

k) A mining engineer who received a share of future mineral production for his services in bringing operators and owners together was held entitled to a depletion deduction. His contract rights were deemed an economic interest in the mines.

(*William R. Van Slyke, Jr.* v. *Kelm*, U. S. District Court, Minnesota, September 15, 1952.)

## Section 102 Surtax

The writer was able to note twelve 1952 decisions dealing with the imposition of the Section 102 surtax for improper accumulation of surplus. The government was successful in only three of them. In those three decisions the courts noted the following:

(1) Taxpayer's claim that $100,000 out of its $156,000 surplus was required to erect a new theatre "within a reasonable time in the future" was rejected because the existing structure was available for 3½ years under lease and the corporation had never considered the purchase of any particular parcel of land. Corporate minutes, ostensibly setting forth taxpayer's intent, were considered "self-serving statements of a sole stockholder" and were to be "weighed as such."

(*Twin City Theatres*, Tax Court Memo Decision, May 12, 1952.)

(2) The surtax was levied notwithstanding taxpayer's assertions that its accumulation of surplus was needed for the following reasons:

(a) The business was extremely hazardous due to wide fluctuations in inventory prices.

(b) Taxpayer's demolition activities gave rise to grave risks of loss of life and property.

(c) Business was highly competitive.

(d) The financial resources of taxpayer often determined ability to bid on larger contracts.

The court suggested that the taxpayer's line of reasoning would have been persuasive if it were supported by "evidence detailing specific facts and figures." In other words, taxpayer had

failed to establish a factual basis for anticipating contingencies.

(*United Iron & Metal Co.*, Tax Court Memo Decision, June 17, 1952; appeal pending.)

Where a corporation can *prove* these assertions they will be sufficient to maintain his position.

(*The Columbus Die, Tool and Machine Company*, Tax Court Memo Decision, October 28, 1952.)

A review of the nine decisions in which the taxpayer was successful seems to indicate that the following factors carry much weight with the courts:

(a) Specific orders for equipment placed as at close of taxable year establish basis for propriety of accumulated earnings.

(*Little Rock Towel & Linen Supply Company*, Tax Court Memo Decision, January 18, 1952; *World Publishing Company*, U. S. District Court, Northern District of Oklahoma, February 29, 1952.)

(b) An e x p a n d i n g corporation which can establish a reasonable basis for expecting increases in future inventories and accounts receivable will generally succeed in proving its right to build up its surplus for these needs.

(*The Lannom Manufacturing Company, Inc.*, Tax Court Memo Decision, February 21, 1952; *Metal Office Furniture Co.*, Tax Court Memo Decision, October 28, 1952.)

(c) If investments in stocks of other corporations are made in the normal course of taxpayer's expansion policy, they will be considered proper utilization of surplus funds even though said investments do not result in *wholly-owned* subsidiaries.

(*The Crawford County Printing and Publishing Company*, 17 TC 1404, February 29, 1952.)

(d) The distribution of *stock* dividends rather than *cash* dividends was not indicative of a desire to accumulate surplus unreasonably where taxpayer was able to prove enormous expansion and severe risks of operation. The court pointed to a low current asset ratio, absence of investments in unrelated industries, low cash and/or bond balances, etc. to support its findings.

(*Kimbell Milling Co.*, Tax Court Memo Decision, March 7, 1952.)

(e) Repurchase by corporation of a portion of its own stock at a premium price was proposed by Commissioner as evidence of an improper accumulation of earnings. Court accepted testimony by the corporate officers to the effect that the purpose behind such repurchase was to insure continued harmonious operations.

(*Gazette Publishing Company* v. *Self*, U. S. District Court, Eastern District of Arkansas, March 28, 1952.)

## Loan v. Capital Stock

Whether a stockholder's advance to a corporation is a true debt or represents an additional stock investment is an important and oft-litigated issue. Its resolution determines whether:

a) a corporate-debtor has paid deductible interest or a non-deductible dividend.

b) a stockholder-creditor has incurred a bad debt or suffered a worthless stock loss (capital loss).

Although it has not been the subject of any of the cases on point, the writer feels that an even more significant issue that may arise in this connection is whether a substantial principal payment on a purported stockholder's loan may be deemed instead a distribution taxable as a dividend under Section 115(g) I.R.C.

Because of its frequency of occurrence and the importance of a correct

solution, this problem is of major concern to most practitioners. A review of some of the pertinent cases on the subject should be helpful.

At the inception of a corporation, the Commissioner and presumably the courts will frown upon a "thin" capitalization. They can be expected to treat stockholders' loans as additional stock investments where:

a) The amount paid in for capital stock is insufficient to accomplish the initial function for which the corporation was formed, e.g., the acquisition of a parcel of real estate, etc.

b) The equity capital is insufficient to provide the corporation's working capital requirements.

c) The capital structure is such that additional advances are required and automatically assumed at inception.

d) The additional advances are made in proportion to stockholdings.

e) The advances are not evidenced by notes having a fixed maturity date, interest rate and a provision for legal action upon default.

(*Samuel T. Tauber,* Tax Court Memo Decision, March 28, 1952; *William Bernstein,* Tax Court Memo Decision, February 8, 1952; *George L. Sogg* v. *Commissioner,* CCA-6, February 8, 1952; *Alfred R. Bachrach,* 18 TC—No. 57, June 10, 1952; *Hilbert L. Bair* v. *Commissioner,* CCA-2, November 7, 1952.)

It is significant that loans made some time *after* the original incorporation have been considered the equivalent of stock where the financial condition of the corporation was such as to make uncertain the eventual collection of the full advance. Loans made under such circumstances were considered suspect even though not in proportion to stockholdings.

(*W. L. Chesshire,* Tax Court Memo Decision, February 19, 1952; *Erard A. Matthiessen, et al.* v. *Commissioner,* CCA-2, February 15, 1952; *Samuel Tauber, supra.*)

That the foregoing conclusions are not crystal clear in the minds of the judiciary may be gathered from the fact that the validity of a stockholder's loans was upheld in another case because they were made in the two years following incorporation and were not in proportion to stockholdings. Nor was the court influenced by the unsound financial condition of the debtor corporation.

(*Oren M. Durham,* Tax Court Memo Decision, March 12, 1952.)

Where a corporation was adequately capitalized for its initial venture but received additional loans from its sole stockholder to finance further deals, these loans represented bona fide indebtedness even though they amounted to $272,000 while the amount paid in for stock was only $50,000. It should be noted that the loans were on open account and no interest was paid thereon.

(*C. Walter McCarty* v. *Cripe,* United States District Court, Indiana, May 22, 1952.)

Carelessness upon incorporation of a partnership may cause future problems. In one case a partnership with a combined capital of $76,000 was incorporated with a stated capital of $50,000. The balance of $26,000 was reflected as an open account loan bearing no interest, having no maturity date and calling for no security. The Tax Court ruled that there was no adequate explanation for fixing the capital at $50,000. Hence the $26,000 loan was considered as an additional stock investment. The writer feels that the taxpayers could have avoided difficulties if they had withdrawn $26,000 of assets from the partnership, incorporated the residual partnership and then made cash advances to the corporation as required and evidenced by interest-bearing notes.

(*Joseph H. Hubbard et al.,* Tax Court Memo Decision, September 26, 1952.)

The formation of a simple real estate corporation may be influenced by the findings of the Tax Court which approved the *bona fides* of debenture bonds issued along with stock upon incorporation in exchange for real

property. In this connection the court noted the following:

a) The market value of the property was at least as great as the combined face amount of stock and bonds.

b) The ratio of debt to equity was 3½ to 1.

c) The debentures were freely transferable without the stock, had no voting power, bore interest and reflected a fixed maturity date.

d) The fact that bonds and stock were issued in same proportions was not sufficient to affect decision.

(*Ruspyn Corporation,* 18 TC—No. 43, July 22, 1952.)

In another decision decided favorably for the taxpayer, the foregoing set of facts was complicated by the finding of the court that a "thin" incorporation was involved. However, it was noted that stock and notes were not in same proportion and this was sufficient to sustain validity of debts.

(*B. M. C. Manufacturing Corp.,* Tax Court Memo Decision, April 16, 1952.)

In two late 1951 decisions the Commissioner questioned the validity of securities issued in exchange for stock. The Tax Court ruled that the indebtedness in both instances were bona fide and allowed the deduction of interest thereon. "Unless tax saving is the sole purpose, there is nothing to prevent a taxpayer from exchanging an instrument of proprietorship for one of indebtedness." Whether the Commissioner would have been more successful if he had attacked the exchange from the point of view of the stockholder recipients is a question to conjure with.

(*Sabine Royalty Corporation,* 17 TC 1071, (Acq.), December 29, 1951; *H. E. Fletcher Company,* Tax Court Memo Decision, October 26, 1951.)

Finally it should be noted that where an individual taxpayer was deemed in the business of exploiting patents either directly or by organizing, financing and participating in the management of various corporations, he may deduct as a business bad debt (fully deductible) an uncollectible loan to one such corporation.

(*Estate of J. S. Stokes,* Tax Court Memo Decision, November 21, 1951; appeal pending.)

### Real Estate

Advance payments of rent constituted income when *received* by an accrual-basis taxpayer notwithstanding the fact that they were to be used to finance construction of necessary improvements required under the lease. Thus income may result in one year with off-setting deductions available only over a term of years. It might be advisable for the tenant to arrange for an outside loan secured by the lease instead of being financed by advance rent payments.

(*Palm Beach Aero Corporation,* 17 TC 1169, January 15, 1952.)

Where the lease specifies that an advance payment to be received by the landlord is security to insure proper performance by the tenant and is returnable unless appropriated to make good a default by said lessee, the payment will not be taxed as rent when received.

(*John Mantell,* 17 TC 1143 (Acq.), January 14, 1952.)

On the other hand, this must be spelled out in the lease and must not merely represent the intention of both parties. Correcting an original lease to spell out this intent will not hold water with the court.

(*Jack August et al.,* 17 TC 1165, January 14, 1952.)

The act of increasing a mortgage to a point where it exceeds the cost basis of the mortgaged property does not create taxable income. Foreclosure of such a mortgage will, however, create income even though there is no personal liability on the indebtedness.

(*Woodsam Associates, Inc.* v. *Commissioner,* CCA-2, July 8, 1952.)

A sale of real estate subject to the

right of possession being retained by the seller for a term of years is recognized as a sale but the income for the retained term is taxed to the seller.

(*McCulley Ashlock*, 18 TC—No. 49, May 28, 1952.)

Similarly, a sale of lands subject to a lease was held a bona fide sale fixing the year of deductibility of the loss therefrom.

(*Wisconsin Electric Power Company*, 18 TC—No. 48, May 23, 1952.)

The sale of a mining claim under an agreement reserving to the sellers for a 30-year term the right to all ore in excess of 1,000,000 tons was deemed a sale and not a lease.

(*Arthur E. Moreton*, Tax Court Memo Decision, May 14, 1952.)

The holding period of a constructed building starts with the date of its completion.

(*M. A. Paul*, 18 TC—No. 71, June 23, 1952.)

A group of eight individuals operating a hotel property under a long-term lease as a joint venture subject to a trust agreement was not considered an association taxable as a corporation. The Commissioner's contention that there was centralized management was rejected.

(*The Olmstead Hotel*, Tax Court Memo Decision, June 30, 1952; appeal pending.)

### When Taxable or Deductible

Bonuses to employees were accruable in the current year when authorized by the Board of Directors although payment wasn't made until the following taxable year.

(*Produce Reporter Company*, 18 TC 69, April 10, 1952.)

Deductions erroneously allowed in barred years may not be arbitrarily added back to income in the year of examination merely because the deduction secured an unwarranted tax benefit.

(*Streckfus Steamers, Inc.*, 19 TC—No. 1, October 6, 1952.)

Conversely, however, it was also held that income improperly taxed in a prior year under a Bureau settlement could be included again in a current year's taxable income.

(*Motors Securities Company Inc.*, Tax Court Memo Decision, March 30, 1952.)

In a somewhat questionable decision the Tax Court ruled that income from a subcontract did not accrue, even though completed, when the right to demand and receive payment came into existence in the subsequent year. The contract provided that the prime contractor was not obligated to make payment until he himself had been paid by the owner.

(*H. W. Lancaster*, Tax Court Memo Decision, November 17, 1952.)

Where interest on an obligation is not payable except out of income and only when declared, it is deductible to an accrual basis taxpayer in the year the contingent liability becomes absolute.

(*Pierce Estates, Inc.* v. *Commissioner*, CCA-3, March 6, 1952.)

Where the Commissioner switches a taxpayer's *method of reporting income* for tax purposes from the cash to a true accrual basis he must give proper effect to the opening inventory and accounts receivable.

(*Commissioner* v. *Marion Richard Schuyler*, CCA-2, April 14, 1952; *Commissioner* v. *George H. Cohn*, CCA-2, June 3, 1952; *George V. Gilbert*, Tax Court Memo Decision, June 18, 1952; appeal pending.)

These do not represent cases where an improper *method of accounting* had been adopted by the taxpayer and changed by the Commissioner, but merely instances where the taxpayer *reported* his income improperly *for tax purposes*. It should be noted that the court denied a negligence penalty where the deficiency resulted primarily from the change in the method of reporting income. (*George V. Gilbert*, *supra*). On the other hand where the books of account as well as the tax returns reflect the wrong method of ac-

counting, the Commissioner, in making his adjustments at the close of the year, is not obliged to make similar adjustments at the beginning of the year.

(*J. H. Welp* v. *U. S.*, U. S. District Court, Northern District of Iowa, March 10, 1952; appeal pending.)

A loss is deductible in the year incurred and not in a subsequent year when cash is actually advanced to cover the investment even to a cash basis taxpayer.

(*Estate of Charles D. Carter* v. *Commissioner*, CCA-6, February 18, 1952.)

### Excess Profits Tax

Many of the 1952 decisions involving the World War II Excess Profits Tax would appear to be applicable to the present law and are outlined below:

(a) Where a taxpayer corporation elects to exclude discount on reacquired bonds from taxable income under Section 22(b)(9) I.R.C. and instead adjusts the basis of its assets, it may not include said discount in its accumulated earnings for invested capital purposes.

(*Bangor and Aroostok Railroad Company* v. *Commissioner*, CCA-1, December 31, 1951.)

(b) The cancellation of indebtedness by a non-stockholder represents an item properly includible in equity invested capital as property paid in as a contribution to capital to the extent of the basis of the debt in the hands of the contributor.

(*Crean Brothers, Inc.* v. *Commissioner*, CCA-3, March 17, 1952.)

The Tax Court has specifically refused to follow the *Crean* decision on this point.

(*The Akron Dry Goods Company* v. *Commissioner*, 18 TC—No. 143, September 29, 1952.)

(c) Under the prior act an indebtedness was includible in borrowed capital only if it was "bona fide". Under the present excess profits tax law a loan constitutes borrowed capital if "incurred in good faith for the purposes of the business." The determination of the nature of a corporate liability from the foregoing point of view was discussed in two 1952 decisions.

Loans used to purchase government bonds were properly considered as borrowed capital.

(*Scofield* v. *John Bremard Company*, CCA-5, June 12, 1952.)

In another case, taxpayer corporation borrowed money to buy Federal Land Bank bonds. The interest cost on the debt was greater than the interest income from the bonds. The investment was made on the mistaken notion that the interest expense would be deductible while the interest income would be exempt, thereby producing a substantial tax savings. There was no evidence to show that the purchase of the bonds was motivated by a desire to increase its credit. The Tax Court ruled that the loans represented "borrowed capital" having been motivated by a business purpose.

(*Pacific Affiliate, Inc.*, 18 TC—No. 146, September 30, 1952.)

(d) Stock issued for services rendered may not be included in equity invested capital. "The services, however valuable, are neither money nor property nor is their value known. Upon this basis, therefore, no inclusion in equity invested capital is warranted . . . since neither money nor property was paid in."

(*Bard-Parker Company, Inc.*, 18 TC—No. 152, September 30, 1952.)

(e) The Tax Court refuses to follow *The Stanton Brewery, Inc.*, case (C.C.A.-2) and denied to a parent corporation the use of the unused credit of a merged subsidiary.

(*California Casket Company*, 19 TC—No. 7, October 15, 1952.)

### Miscellaneous Deductions

Practitioners and taxpayers alike are always interested in cases involving tax deductions. The following were deemed noteworthy of mention:

(1) Payments in settlement of O.P.A. suits under the World War II

law were allowed as ordinary and necessary business expenses:

(a) Where the price increases were innocently made in contemplation of an O.P.A. order which was never issued, although officials had indicated it would be.

(*Hershey Creamery Company* v. *U. S.*, Court of Claims, January 8, 1952.)

(b) Where the overcharges were innocently made and taxpayer had exercised due and adequate care to conform to the law.

(*Maier Brewing Company* v. *U. S.*, U. S. District Court, Southern District of California, January 30, 1952; *Ben B. Bodne*, Tax Court Memo Decision, May 12, 1952; *Michael Markovits*, Tax Court Memo Decision, July 31, 1952.)

Where taxpayer cannot prove that overcharges were innocently and unintentionally made, the same payments are "penalties" and cannot be deducted.

(*Estate of Walter Norwood*, Tax Court Memo Decision, May 27, 1952; *Almor Dress Co., Inc.*, Tax Court Memo Decision, September 25, 1952.)

(2) Amounts spent by an executive employee entertaining salesmen under his supervision were held deductible as ordinary and necessary expenses of his business as field manager. Taxpayer was able to prove that maintaining friendly relations between himself and his salesmen had a direct relation to his compensation as sales executive.

(*Harold A. Christensen*, 17 TC 1456, March 7, 1952; Acq.)

(3) Payments "in lieu of interest" by a husband to his wife-creditor under an agreement to give her 25% of the profits of his business were held deductible as interest. Under the prevailing local law, interest was deemed payment for the use of money, and there is no limitation as to the amount or rate of interest which is deductible for tax purposes.

(*Karl D. Dorzback* v. *Collison*, CCA-3, March 18, 1952.)

Carrying charges on installment sales are deductible as interest if separately stated.

(*Arthur S. McKenzie; Oliver W. Bryant*, Tax Court Memo Decisions, May 2, 1952.)

(4) Where income tax issues causing a deficiency were being contested over a period of time, the additional New York State franchise tax resulting from those adjustments did not accrue until the Federal case was settled.

(*Concord Lumber Co., Inc.*, 18 TC—No. 104, August 5, 1952.)

(5) Contributions to an employees' social welfare trust which helped taxpayer's employees in financial distress because of illness, injuries or unemployment in the family were deductible even though the trust did not qualify under Sections 23(p) and 165 of the Internal Revenue Code. They are deductible, however, as charitable contributions and subject to their limitations.

(*J. T. Moss Tie Co.*, 18 TC—No. 25, May 7, 1952; appeal pending.)

(6) An amount subscribed and paid to a development and promotional association of merchants for advertising, the benefits of which were expected to extend over a period of years, was deductible in full in the year of payment.

(*Consolidated Apparel Co.*, 17 TC 1570, March 21, 1952; appeal pending.)

(7) Expenses incurred in the development of a new product were held to be capital expenditures and not deductible.

(*J. R. Clem*, Tax Court Memo Decision; December 29, 1951.)

Research and development expense which led to the development and procurement of patents are capital expenditures, but those which did not are deductible currently as ordinary and necessary business expenses.

(*Lanova Corporation*, 17 TC 1178, January 16, 1952; Acq.)

The problem of the proper tax handling of research expense was finally made the subject of a policy statement by

Commissioner Dunlap before the Joint Committee wherein he stated, "It is the policy of the Bureau where the taxpayer under its established method of accounting has elected to adopt the practice of charging to expense research and development costs, to allow such costs as deductions in computing net income."

(8) Where a trust remainderman purchases a life estate from an income beneficiary, he is entitled to recover his cost by amortization deductions over the life expectancy of such beneficiary. This case seems worthy of further study by tax practitioners as a means of converting high bracket income into capital gain.

(*Laird Bell* v. *Harrison*, U. S. District Court, Northern District of Illinois, September 17, 1952.)

(9) Corporate taxpayers, whose taxable years under the old excess profits tax law are still open, should note that the Courts of Claims has ruled that the net operating loss must be calculated by allowing as a deduction the excess profits tax for the preceding year paid during the year of loss, notwithstanding the fact that the taxpayer is on the accrual basis.

(*Olympic Radio & Television, Inc.*, U. S. Court of Claims, November 4, 1952.)

This would appear to conflict with the Tax Court's view.

(*Lewyt Corporation*, 18 TC—No. 151, September 30, 1952.)

Pending further adjudication of this issue, protective claims should be filed where applicable.

Those same taxpayers might also be affected by the decision of the Court of Claims in the case of *Wickes Corp. v. U. S.* (December 2, 1952), which held that certifying authorities during World War II were without authority in limiting the amount of an emergency facility subject to amortization to a percentage of its cost. They were also acting invalidly in refusing to certify facilities acquired prior to the date an application for a necessity certificate was approved. Taxpayers seeking to compel the issuance of a necessity certificate covering the *entire* cost of an emergency facility had previously been unsuccessful in the courts. This issue may also have to be resolved by the Supreme Court.

(10) A voluntary payment by an attorney to his client to reimburse the latter for an investment loss incurred as a result of the attorney's advice was not deemed an ordinary and necessary business expense or a deductible loss.

(*Alexander Slater*, Tax Court Memo Decision, March 20, 1952; appeal pending.)

(11) Where an individual overstates and exaggerates his deductions, a negligence penalty may be imposed on the ensuing deficiency.

(*Julian A. Martin*, Tax Court Memo Decision, September 22, 1952.)

(12) Expense incurred in connection with a partial liquidation were prorated as follows for tax purposes:

(a) Portion attributable to the distribution of assets—deductible.

(b) Portion attributable to the redemption of stock — non-deductible.

(*Tobacco Products Export Corporation*, 18 TC—No. 138, September 25, 1952.)

### Miscellaneous Decisions re Taxable Income

Where a lump sum of money is received in settlement of various claims, an allocation of specific amounts to each claim may be made where a reasonable basis exists therefor. Where the claim is for lost profits or to recover expenses, the recovery constitutes taxable income; where an amount is received for punitive damages it does not constitute taxable income.

(*Glenshaw Glass Company*, 18 TC—No. 108, August 13, 1952.)

The courts will not always permit a breakdown of a lump sum receipt where the award itself does not provide for same, as for example, in condemnation payments where the tax-

payer has sought to allocate between an amount received for the lost property and damages to the retained property. However, in another instance a subdivision by the taxpayer was permitted. A breakdown of insurance proceeds between depreciable property and inventory was allowed even though it resulted in a long-term capital gain and an ordinary loss.

(*Lehman Company of America,* 17 TC 622, September 26, 1951; Acq.)

The income realized upon the *sale* of a note previously written off as worthless with tax benefit is ordinary income and not a capital gain.

(*Merchants National Bank of Mobile* v. *Commissioner,* CCA-5, November 10, 1952; appeal pending.)

The receipt of a new note consolidating in its face amount the old note plus accumulated interest does not result in taxable income to a cash basis taxpayer.

(*Joe W. Scales,* 18 TC—No. 153, September 30, 1952.)

The purchase of an annuity by an employer for an employee may be entirely taxable to the latter in the year of vesting. This is not so if the annuity is acquired from an exempt trust.

(*Elliot C. Morse,* 17 TC 1244, January 28, 1952; appeal pending.)

The Tax Court affirms the rule that no income is realized on principal collections on notes purchased at a discount until the entire cost is collected where there is uncertainty of payment by the debtor.

(*Webster Atwell,* 17 TC 1374, February 27, 1952.)

**Taxes Generally**

a) Interest on a deficiency is not eliminated by a loss carryback which eliminates the deficiency even where said deficiency was never assessed.

(*Harry Newman Rodgers Sr.* v. *U. S.,* Court of Claims, December 2, 1952.)

The Supreme Court had previously ruled in the *Seeley Tube and Box Co.* case that interest on an *assessed* deficiency remains payable even though the deficiency is wiped out by a carryback loss.

b) An overstatement of an item of cost of goods sold will be deemed to result in an omission of gross income and, if sufficient in amount, may extend the statute of limitations for an additional two years.

(*Uptergrove Lumber Company,* Tax Court Memo Decision, July 16, 1952; appeal pending.)

c) Where taxpayer sought, received and relied upon qualified professional advice, it was not held liable for the negligence penalty resulting from:

1) failure to file a personal holding company return.

(*Western Transmission Corporation,* 18 TC—No. 100, July 30, 1952; *Burton Swartz Land Corporation* v. *Commissioner,* CCA-5, July 24, 1952.)

2) failure to file an income tax return because of a mistaken belief that it was an exempt organization.

(*American Association of Engineers Employment, Inc.,* Tax Court Memo Decision, March 7, 1952; appeal pending.)

d) Renunciation of a specific bequest or of an intestate share of an estate constitutes a taxable gift.

(*William L. Maxwell,* 17 TC—No. 196, March 26, 1952; *Ianthe B. Hardenbergh* v. *Commissioner,* CCA-8, June 24, 1952.)

e) Taxpayer's arbitrary mark-down of closing inventories, presumably to account for a depreciation in its value, was disallowed for lack of proper basis and substantiation.

(*John L. Ashe, Inc.,* Tax Court Memo Decision, February 29, 1952; appeal pending.)

f) A corporate return signed only by one officer was an improper return, the equivalent of no return having been filed at all. Not only is the delinquency penalty assessable but the tolling of the

(Continued on page 206)

# Claims for Refund or Revision of New York State Franchise and Income Taxes

*By* Frederick J. McCarthy, C.P.A.

*This paper discusses the methods of handling refunds and revisions under the New York State franchise and income tax laws, as well as the relevant tax department practices and procedures.*

The question of refunds gives rise to various problems and procedures, a complete and detailed discussion of which would take considerable space. I shall attempt, however, to cover what I believe to be the more important points relative to the recovery of taxes paid and the abatement of taxes not yet paid.

The discussion will be confined to the claims for refund or revision of the franchise tax of business corporations and the income tax of individuals, resident and non-resident.

Consideration will therefore be given to the various causes from which claims for refund or revision may arise together with the procedures before, and the requirements of, the State Tax Commission in clearing these claims.

Frederick J. McCarthy, C.P.A., has been a member of our Society since 1944, and of the American Institute of Accountants since 1949. He is now serving as Vice Chairman on the Society's Committee on State Taxation.

Mr. McCarthy is engaged in practice as a Certified Public Accountant with the firm of Peat, Marwick, Mitchell & Co.

This paper was presented by him at a technical meeting of the Society held on October 30, 1952, at the Engineering Societies' Building, under the auspices of the Committee on State Taxation.

## Corporations

Of the reasons for filing claims for refund or claims for revision the following are the most common: errors on the return, changes made by the Federal government which result in overassessments, renegotiation of contracts by the Federal government, and direct assessments by the State Tax Commission.

### Statute of Limitations

The Tax Commission requires an application for revision of franchise tax, either under Article 9 or Article 9-A of the tax law to be filed on its form 7CT. It is, I believe, unnecessary at this time to discuss the preparation of the application; however, the period within which form 7CT must be filed in order to give the Tax Commission authority to act deserves our attention.

Application for revision must be made within two years, *not* from filing date, but from the Audit or Assessment date. This differs from the Federal rule, the Federal dates being fixed by filing and for payment dates. However, if a return has been reaudited or restated, then claim for revision must be filed within one year from the restatement date.

For the purposes of clarity, it must be understood that the taxpayer on its report computes the amount of tax which it believes payable under the law. The State Tax Commission thereupon "audits and states an account" for the tax; that is to say, the State Tax Commission examines the report, computes

the amount of tax payable under the law and sends the taxpayer notice thereof, *which constitutes the original assessment of the tax.*

### Form 7CT

These forms are not distributed by any district office, including New York City. They are obtained from the Corporation Tax Bureau, Albany, New York, upon written request. The request must contain the name of the taxpayer, and details concerning the reasons for revision or refund. It is quite possible that claims may be settled by this correspondence thereby obtaining a relief from all formalities. A separate form must be filed for each year for which a refund is claimed, and indication must be made on the form as to whether the claim is made under Article 9 or 9A. There must be set forth, in detail, the basis for the claim, with a statement of the amount actually being claimed.

### License Fee (Sec. 181 Art. 9)

When a change is made in the capital structure of a foreign corporation or in the amount of capital stock employed in this state, the license fee shall be recomputed (Form 240 CT) on the basis of such change, and there shall be credited against the recomputed fee the amount of any fee previously paid. But if the fee previously paid exceeds the fee as recomputed, there shall be *no refund.*

### Interest

If the Tax Commission ascertains that the taxpayer has overpaid its tax the Commission will credit (or refund) the taxpayer with the amount overpaid *without interest.*

### Renegotiation of Contracts and Federal Findings

As indicated in my last address renegotiations are now treated in the same manner as Federal findings. Accordingly, the special New York State statute of limitations, relative to Federal findings, applies to renegotiations. These changes may be reported within 90 days of final determination, or on the next report required under Article 9A. This would be reflected on "Schedule H", Page 3, of the 3CT return.

It should be pointed out that there is no provision under Article 9 for filing information relative to Federal findings. This is because the basis of the tax under Article 9 is generally Gross Receipts, or Assets and Dividends, but not Net Income. However, your attention is directed to an exception under Sec. 182 of Article 9. The Federal government, for example, may disallow Officers' Salaries as being unreasonable and excessive in say the amount of $50,000. This would then be considered a dividend and subject to the 2% tax under Article 9.

Where it has been reported by taxpayer that an overassessment was determined by the Federal government, the revenue agent's report, together with a photostatic copy of Form 7776, Cert. of Overassessment, should be submitted by the taxpayer to the Corporation Tax Bureau.

The changes made by the Federal government and as submitted by the taxpayer are subject to approval by the Tax Commission. If the Commission decides that the changes as reported are proper, and that income has thereby been decreased from that originally reported to the state, the corporation generally speaking is entitled to a refund. Regarding the necessity of filing an application for revision following reduction in net income by the Federal government, the Commissioner, in a ruling dated September 15, 1949, expressed the opinion that such application is not necessary. However, if the taxpayer is dissatisfied with the reaudit and restatement made upon the reporting of Federal changes, an application on Form 7CT may be filed within one year from the reaudit and restatement date (under Sec. 214.1).

### Refund and Credit

Should the Tax Commission decide that taxes had been overpaid, it may either credit the corporation with the amount of overpayment, or it may direct that the amount of credit be refunded to the corporation.

If the corporation is merely credited with the overpayment, the corporation may assign the credit. It should be noted that the credit resulting from revision can be assigned to any taxpayer subject to tax under the same article. Thus a credit under Article 9-A can be assigned only to a taxpayer subject to tax under 9-A, and a "credit" under Article 9 can be assigned only to a taxpayer subject to tax under Article 9. However, refund checks are never so assignable.

### War Losses

These are generally not the subject of refunds. It is presumed that "War" losses have been deducted to the extent allowed by the Federal government. However, there are no *special* provisions dealing with war losses either under Article 9A or 9—the general provisions would, therefore, apply.

### Judicial Review

Additional assessments may have been made to which the taxpayer takes exception. If, after formal and informal hearings, the taxpayer decides to take further action, such action must be brought in the Supreme Court of New York.

The action must be brought within 90 days from receipt of Tax Commission's final determination. Eight days' notice is required by the Tax Commission. The taxes in question must be paid or the payment thereof fully secured.

## Individual Income Tax—Resident and Non-Resident

### Statute of Limitations

It is significant to note that the period in which a claim for refund must be filed under the income tax law (Article 16 and Article 16-A) is within two years from the *time of filing of the return*, or within one year from the time of recomputation or assessment, whichever is later. For the purposes of determining the two-year period in which to file a claim for refund, *the actual date of filing is considered.* The State Tax Commission has provided Form I.T. 113 for this purpose.

### Period of Limitation

The Tax Commission must examine the taxpayer's return and determine the amount of tax due within 3 years after the return was made (Section 373). A return is considered as having been filed on its due date even though it was filed before then. If an extension of time for filing has been granted, the return is considered to have been filed on the last day of the extended period.

### Form IT-113

The application for refund or revision must be signed under oath and filed in duplicate. It must set forth in detail sufficient facts to state clearly the basis of the claim.

An application for refund may be filed within one year from the time of recomputation even though a claim for refund was not filed within two years from the time of filing the return. The Tax Commission may consider the facts stated on this application and may grant relief, but only to the extent of any additional amount of taxes shown to be due by the recomputation.

### Form I.T. 114—Demand for Hearing

If the taxpayer has been notified by mail that his application for revision or refund has been denied in whole or in part he may demand a hearing on Form I.T. 114. This must be filed by the taxpayer within 90 days after notice of denial. If it is shown upon the hearing and the evidence submitted that there has been an illegal demand and payment, the Commission will revise and resettle and mail notice of its determination to the taxpayer.

Where an application for revision (Form I.T. 113) has been timely filed, and it develops at the hearing before the Tax Commission that there were errors on the return that were not set forth in the application, such omission does not bar the present correction of such errors.

### Interest on Refunds

As to payment of interest refunds by the State, there is no expressed provision in the tax law. However, under Article 16, the Income Tax Bureau will include interest where a tax has been illegally exacted. No general rule is laid down, each case being governed by the circumstances surrounding it.

### Recomputation of Tax as a Result of Changes in Federal Return Resulting in Overassessment, and Renegotiation of Contracts

If the amount of net income for any year of any *taxpayer* as returned to the Federal government is changed or corrected by the Federal government and the result is an overassessment, or when a renegotiation of a contract or subcontract with the United States results in a reduction of net income, such taxpayer shall report the changes within 90 days after the final determination. However, a nonresident taxpayer shall give such notification *only* if the change or the result of renegotiation relates to income taxable to a nonresident under Article 16. The Tax Commission has approved Form I.T. 115 for this purpose.

### Form I.T. 115

This form provides for the presentation of changes by the Federal government and serves as a claim for refund. In using this new form, the taxpayer must still comply with the ruling to report Federal changes to the State Tax Commission within 90 days after final determination. The form must be filed separately and not attached to any return.

The State, it might be mentioned, is not bound by Federal governmental changes.

## Nonresidents

### Claim for Credit by Nonresidents for Taxes Paid to States or Countries with Reciprocal Agreement

A nonresident of New York State seeking credit on New York State returns for income taxes paid to the State or country of his residence must complete Form IT-112 and attach it to the return for the year in which he is seeking the credit.

However, failure to file Form IT-112 with the current return will not in, and of itself, prevent the nonresident from getting benefit of such a credit if within the period provided by law (2 years from date of filing return) he files an application for refund in the Form IT-113 which we previously considered.

### Form 203—New York State Income Tax—Nonresident Return

Where the tax withheld at source is in excess of the actual tax due, the amount in excess will be shown on line 20-b and the return itself will then be deemed to be a claim for refund of the excess as is so stated thereon; hence no other form need be filed.

Ordinarily, nonresident returns showing overpayments of income tax are examined as soon as possible so as to determine the amount of tax and to pay the refund. At times, however, where cross references are required, the refund may be delayed.

### War Losses

These are treated under the applicable provisions of section one hundred twenty-seven of the United States Internal Revenue Code.

Notwithstanding any provision of the Tax Law, an application for revision or refund under this section (358-b) with respect to the years beginning January 1, 1951, January 1, 1952, and the fiscal years ending in 1942 and 1943

may be made on or before April 15, 1951.* (Chapter 193, Laws 1950).

**Abatement of Tax of Members of Armed Forces Upon Death**

No tax is imposed in the year of death, after Dec. 7, 1941, on any person who dies while on active service as a member of the armed forces of the United States, and no return is required to be filed in behalf of such person or his estate. If any taxes have been paid or collected with respect to the year of death, they shall be refunded to the widow or legal representative. (Section 378.)

**Credits Against Unpaid Taxes**

Where a deduction is disallowed in a given year on the ground that it is applicable to a prior year, but not more than five years prior thereto, the Tax Commission may revise the tax for such prior year and recompute the tax. Any resulting overpayment may be allowed as a credit against the additional assessment in the later year, but not in excess thereof. (Section 373-1.)

**Other Refunds**

Section 373.3 of the Tax Law, under *Powers of Tax Commission,* grants authority to issue refunds under certain conditions. Mr. Harrow in his latest book† on New York State taxes explains these as follows, and I quote from Paragraph 4819 (page 711):

"*Refunds—on initiative of Commission.*

"The Tax Commission is empowered on its own initiative to issue a certificate entitling a taxpayer to a refund of taxes, 'where no questions of fact or law are involved and it appears from the records of the Tax Commission that any moneys have been erroneously or illegally collected from any taxpayer or other person, or paid by such taxpayer or other person under a mistake of facts.' (Section 373.3). The Commission is required to make a record in writing of its reasons for issuing such certificate of refund.

"A refund under this section is an exception to the three-year limitation. The conditions for such a refund are as follows:

"1. No question of law is involved.
2. No question of fact is involved.
3. All the facts are in the reeords of the Tax Commission.

"This provision is employed where a decision of a court reverses a ruling of the Commission, and also in cases where a refund is clearly due but was overlooked in the course of audit. The regulations state that this power is ordinarily limited to cases where arithmetical or other errors of computation are clearly shown upon the face of the return filed. (Art. 573.)"

* April 15, 1951, was the last extension granted.

† *New York State Income and Franchise Taxes* (Second Edition), by Benjamin Harrow. PRENTICE-HALL, INC., New York, 1951.

## Significant Tax Decisions of 1952

(Continued from page 201)

statute of limitations has not been started.

(*Pike Holding Company,* Tax Court Memo Decision, February 8, 1952.)

g) No gift tax is due on profits retained by taxpayer's wife and trusts even though said profits have been taxed to him for income purposes.

(*Estate of Andrew H. Blass,* Tax Court Memo Decision, June 19, 1952.)

# Advertising Agencies – Operation Finance

*By* S. Zachary Scheer, C.P.A.

*An explanation of the nature of the operations of an advertising agency introduces this paper. Then, the author outlines a simplified, time-saving accounting system, from which may be derived the usual accounting reports and supplemental budgetary data.*

The advertising agency business is a personal service business. Each agency operates somewhat differently from any other, but all follow the same basic concepts.

The principal ingredients of an advertising agency are knowledge and experience in the successful advertising of a product or service. These abilities are based on constant study and research.

It is rather strange that, despite the skill required, the largest part of an advertising agency's revenue is derived from a commission (generally 15%) of the selling price of advertising purchased for the client. In other professions or personal service businesses a fee is computed to return the total cost plus a reasonable profit. This limitation of fee is one of many problems faced by advertising agencies.

The presence of trouble is often known but the core of trouble is frequently unknown. In finance, accounting data play a most significant role in highlighting problem areas. This paper will attempt to illustrate how good accounting can assist in the efficient day-to-day operation of the advertising agency business.

S. Zachary Scheer, C.P.A., is a member of the Society and of its Committee on Graphic Arts and Allied Industries Accounting. He is also a member of the American Institute of Accountants. Mr. Scheer is with the firm of J. K. Lasser & Company.

This paper was presented at a technical meeting of the Society held last year, under the auspices of the Committee on Graphic Arts and Allied Industries Accounting.

**Evolution**

Although advertising dates back to the beginning of civilization, the advertising agency is a development of modern times.

Before the 20th century, the advertising agency business was so completely disorganized that agencies did not know if they represented the advertiser or the publisher. Most agencies were space brokers who bought space at wholesale and sold it at retail.

During the early 1900's, agencies began to establish modes and principles of operation. Standard commissions were received by all recognized agencies and service departments were beginning. Working techniques were being clarified.

Around 1930, the functions of an advertising agency had become well known and recognized. Agencies matured to the point of competing for clients on the basis of who could best serve the client.

Today, the advertising agency offers its clients professional service in connection with idea development, product analysis, the development of marketing techniques, the personal attention to writing, lay-out, art work, etc. The agency also handles the commercial elements of the business relating to the purchase of advertising space and materials, the application of capital and regular routines of checking copy, measuring ads, buying printing, billing, paying and accounting.

**Agency's Income**

Agencies generally may be classified as:

1. *General advertising*—these handle clients whose product is advertised to the general public through customary media such as newspapers, magazines, trade papers, farm papers, radio, television, outdoor displays and car cards.

2. *Industrial agencies*—these specialize in the advertising problems of industrial accounts which sell tools, machinery, equipment, etc., to the industrial consumer and not to the general public.

3. *Agency specialists*—these handle advertising of an unusual nature such as financial, foreign, theatrical, retail, etc.

Advertising accounts are classified by size of advertising appropriation. An account whose annual appropriation is $50,000 or less may be considered a small account; one whose appropriation is from $50,000 to $150,000 may be considered a medium-sized account; one whose appropriation is from $150,000 to $500,000 represents a large advertiser; and one whose appropriation exceeds $500,000 is a very large account.

The *commission* received from advertising media constitutes the largest source of income to an advertising agency. Until recently, these commissions compensated the agency for many of the services it rendered. During the past few years there has been a definite trend toward service charges in addition to the standard media commissions. At the present time most agencies include the following services for the media commissions:

1. Developing advertising plans
2. Writing advertising copy
3. Preparing rough layouts
4. Selecting media
5. Purchasing advertising materials required

Today, most agencies charge *service fees* for creative services, such as:

1. Comprehensive layouts
2. Special copy writing
3. Special research studies of markets or products

There are two significant reasons for the current trend toward additional service fees. First, the agencies have become more cost conscious. They are maintaining better cost records and are less inclined to carry the "loss" or "break-even" client. Second, the high cost of developing television advertising makes it impossible to depend solely on commissions from this medium.

Small advertisers are usually handled on a minimum charge basis. This fee is fixed by the agency after it determines the cost of the services required by the advertiser.

The agency receives a service fee for the materials it purchases for clients. It is interesting to note the change in the basis of this fee in recent years. The agency has always strived to receive a 15% fee for this service. However, in past years, the 15% was frequently taken on the cost of the materials, or approximately 13% of billing price. Today, the cost is projected at 85% and an actual 15% of billing price is charged. To illustrate:

| | Old Method | | New Method | |
|---|---|---|---|---|
| | Amount | % Billing Price | Amount | % Billing Price |
| Cost | $340 | 87% | $340 | 85% |
| Fee | 51 | 13 | 60 | 15 |
| Billing Price | $391 | 100% | $400 | 100% |

These recent trends in agency income were necessitated by the marked increases in salaries and wages throughout our economy. Agencies are severely affected by such increases since 58%-70% of an advertising agency's income is spent for salaries.

In the final analysis, what an agency has to sell is the accumulated experience of its personnel. The fees it receives from clients must be based on the amount and cost of services performed for them.

### Credits and Collections

There are two basic principles governing the relationship of client, agency and medium, namely:

1. That the agency is solely liable for payment to media.
2. That the agency shall not finance the advertising of its clients.

The first of these principles is a standard provision in all types of advertising contracts. The rule is strictly enforced in practice. As a matter of fact, an agency that cannot *discount* its media charges is considered a poor risk.

The second principle is one of great practicability. Agencies do not have excess working capital. They are usually organized by people with outstanding creative ability and limited capital. Such capital is needed for daily operations, advertising materials (paid in advance of collection from clients), temporary losses from operations, research, periods of expansion, etc. Agencies must maintain an average working capital approximating one month's billing.

The credit risks taken by advertising agencies are best illustrated by comparison with possible gains. Advertising agencies these days do well to net from one and one-half to three percent of their total sales volume. From this, it will be seen that the agency's net profit from handling the account of a client spending $100,000 would average between $1,500 and $3,000 a year. When it is realized that the agency risks as much as $30,000 or $40,000 (through advance contracts and commitments) to secure a net profit of perhaps $2,000, it will be seen that little further financial risk can be prudently accepted.

The usual credit terms of an agency provide that the client must pay the agency a few days prior to the date on which the agency must pay the media. For all non-media items, the usual terms provide for payment ten days from the date of the agency's invoice. Unless the financial position and integrity of the advertiser are beyond question, these usual terms cannot be granted because the possible gain just isn't worth the risk.

There are a few methods employed to reduce the credit risk. One is to secure payment prior to cancellation dates or require advance payments. Another is to obtain guarantees from a financial sponsor or parent company of advertiser. Occasionally, the medium is willing to accept a credit risk where the agency would not do so; the agency is thus relieved of responsibility. A third way is to cover the amount with credit insurance. As a matter of fact, if the insurance company is willing to accept coverage, it reflects a favorable risk.

### Accounting

The most distinguishing principle of advertising agency accounting is that all advertising space and materials which the agency purchases are *specifically* bought in behalf of a client and that each item so purchased should be billed.

Since the advertising agency must transact $6.67 in business to receive $1.00 in commission (15% of $6.67), a large number of transactions must be handled in even a moderate-sized agency.

To record transactions in the customary Purchase Journals, Accounts Receivable and Accounts Payable Ledgers, following conventional accounting methods used by manufacturing and

jobbing businesses requires an enormous amount of clerical work that is not necessary. Most agencies make use of the peculiarities of the advertising business to simplify recording.

It might be well, at this point, to examine the operating statements required by advertising agency management. The general operating statement usually encountered includes the normal tabulation of results for the month and (three months) cumulative, with a comparison of actual to budget. The major headings in the order used are: Billings, Costs, Commissions and Fees, Direct Expenses, Gross Profit, General and Administrative Expenses, Net Operating Profit, Other Income, Other Expenses, Net Profit. The first three headings include sub-captions segregating classifications of media. These media include the following (as required): Newspapers, Magazines, Radio Time, Radio Talent and Production, Television Time, Television Talent and Production, Outdoor Production, Service Fees, and Non-Commissionable Items.

Schedules of general and administrative expense and direct salaries are presented supplementary to the general operating statement.

This general operating statement should be a recapitulation of individual operating statements prepared for each client. This is an innovation of recent years and there are still many agencies unable to produce these highly informative operating statements by clients serviced. The only difference in form, between the general operating statement and the individual operating statements, is that the latter terminate at gross profit. Studies have shown that an application of general and administrative expenses to an individual advertiser's operations is an extremely difficult item to measure. Such application is, therefore, omitted from the individual operating statements for the sake of more reasonable comparisons.

**Books and Records**

The data required for operations statements are accumulated in many ways by different agencies. The system presented below is simple and time-saving. With modifications, it is the system used in many agencies. The author recognizes that the systems of some agencies do not resemble the outline below. In some instances conventional systems have been awkwardly adapted to fit agency accounting. These same agencies are slowly discovering that they cannot feasibly use such systems for timely, significant reports. A current and orderly preparation of accounting data requires a system essentially as outlined below.

The basic book of original entry in the system presented herein is the *Sales and Cost Journal.* The billing price and cost of every invoice sent to a client of the agency is entered in this journal. The record is designed to:

1. Accumulate automatically the billings and cost of billings for each client, separately.
2. Classify the billings and cost of billings for each client, so that the totals for a month or other period will show the volume of each type of transaction (newspapers, magazines, radio time, advertising materials, etc.) handled for each client.
3. Accumulate the total billings and cost of billings for the agency as a whole and classify them by types of transactions.
4. Provide a record of charges to each client and collections therefor, showing the unpaid items (accounts receivable detail).
5. Form the basis for accumulating figures through which internal controls can be established to assure the billing of all items paid and the paying of all items billed.

The Sales and Cost Journal is summarized monthly and totals posted to the General Ledger. The three summary entries are:

Accounts Receivable
  Sales

Cost of Sales
  Accounts Payable

Cost of Sales, Advertising Materials
  Unbilled Advertising Materials

**Other Books**

1. *Inventory Control Journal* (Memo only)—This book accumulates (by job number) the costs incurred; costs of jobs billed; costs of jobs unbilled; for each client. Costs by client are recapitulated monthly and totals checked to control account.
2. *Voucher Register* (for advertising materials)—This is a book of original entry showing a list of suppliers; the monthly purchases from, payments to and balance due each supplier. The total of the purchases column is posted to unbilled Advertising Materials and credited to Accounts Payable —Advertising Materials.
3. *Expense Voucher Register*—This is a book of original entry for recording:
   (a) Direct client expenses—These are expenses such as traveling, entertainment, research, etc., clearly allocable to each of the several clients. Space is provided for recording the client's name, the type of expenditure and the amount.
   (b) General and administrative expenses—Columns are provided under this heading for recording the regular items of expense not directly allocable to the separate clients. Examples are rent, light, telephone, dues and subscriptions, legal and audit fees.
   (c) New business or sales expenses—These expenses include such items as traveling, entertainment, gifts, etc., and are incurred for the purpose of obtaining new clients. Columns are provided for prospect's name, type of expense and amount.
   (d) Miscellaneous (general ledger) items — These include purchases of furniture, office equipment, securities, etc.

   The monthly summary of this book is posted to respective accounts in the General Ledger.
4. *Cash Receipts Journal*—A simple conventional form is used.
5. *Cash Disbursements*—As noted above in (2) and (3), all items payable by an advertising agency exclusive of payroll are accumulated and credited to one of the following accounts-payable control accounts:
   (a) Publication space, radio time, radio talent and production, and outdoor advertising costs are credited to respective Accounts Payable control accounts directly from monthly totals shown in the Sales and Cost Journal recapitulation.
   (b) The total of the monthly purchases of advertising material is credited to a separate Accounts Payable control account from the totals in the Voucher Register for advertising materials.
   (c) The total of all unbillable agency expenditures as shown in the Expense Voucher Register is credited to the Expense Accounts Payable control account.

Payments chargeable to these Accounts Payable control accounts are obtained directly from adding-machine tapes of file copies of checks. This eliminates the need for a Cash Disbursement Journal. Checks are prepared in triplicate. The duplicate is filed in numerical sequence for the purpose of bank reconciliation. The triplicate copy is filed in numerical sequence separately for space, adver-

tising materials, radio time, radio talent, production, outdoor and expense. (Note: A fourth copy of the check could be attached to each voucher).

**Payroll**

Salaries are summarized monthly by departments. This payroll summary is a columnar record with description columns for Department and Employee, and amount columns for Direct Salaries, Indirect Salaries, Promotion Salaries, Billable Salaries (at cost) and Total Payroll. Employees are listed by departments and salaries inserted in appropriate columns.

Such a summary is required in order to obtain a breakdown for proper recording in the general ledger. For example, departmental totals in Direct Salaries are posted to Direct Expense accounts such as Executive Salaries, Art Salaries, Production Salaries, etc. Departmental totals in Indirect Salaries are posted to Indirect Salary accounts (under General and Administrative expenses) such as Executive, Art, Bookkeeping, Checking, Mailing, etc. Promotional salaries are posted in total to Promotional expenses (under Other Deductions). Billable salaries represent the labor cost of time spent on special projects for clients. The total of the Billable Salaries column is posted to Cost of Billings—Special Projects, (includes special jobs ordered by clients such as market surveys, research projects, etc.)

The distribution of direct salaries by departments is prepared from time reports maintained by key employees. These time reports include time spent on clients' work (direct), time allocated to new prospects, and administrative time charged to indirect salary accounts.

Salaries of employees not maintaining time reports may be considered as indirect in their entirety.

A journal entry is prepared from summary totals. This summary may be used in journalizing the payroll cash disbursements. Usually, a separate bank account is maintained for payroll. The gross payroll amounts are taken from the payroll summary—the net cash and payroll tax deductions are taken from the payroll check vouchers.

The Employer's portion of payroll taxes is, of course, handled by general journal entries.

**Budgets**

The operating statements mentioned above include budget estimates. These budget forecasts are of particular importance in this business of individualized service. The very nature of the advertising agency business facilitates the preparation of budgets. Since service is rendered to each client on a "pre-planned" basis, commissions and fees may be pre-determined. Direct expenses may be forecast on the basis of past experience.

The most significant figure in the advertising agency budget is Gross Profit. It must be at least sufficient to absorb indirect costs. It is important to know not only what the gross profit on each client is, but also what the rate of gross profit should be, on the average. This rate may be determined by computing the ratio of total general and administrative expense of the agency to its total commissions and fees. For example, if an agency has:

| | Amount | % Based On Income | % Based On Billings |
|---|---|---|---|
| Billings | $1,000,000 | | 100% |
| Costs | 850,000 | | 85 |
| Income from commissions and fees | $ 150,000 | 100% | 15% |
| Direct expenses (salaries and expenses chargeable to clients) | 90,000 | 60 | 9 |
| Gross Profit | $ 60,000 | 40% | 6% |

and this rate of gross profit is average, a basis of 25% for general and administrative expense will leave a net profit of 15% before taxes. Note that this 15% net profit based on income is equivalent to approximately 2% net profit based on billings. The basis used in determining operational results, percentage-wise, is optional. The important factor is to be sure that an application of overhead is considered in reviewing operational results of individual clients. Overhead expenses must be recovered, pro-rata, from each client serviced.

The advertising agency business may be less stable than some other types of business. The addition or loss of one account may have an important effect on the operations. Because the total volume of transactions may be affected by events beyond the control of the agency, it may be impossible to prepare an accurate budget for a period of time in excess of a few months. The first budget should be prepared for a period of one year; this budget should then be subdivided into periods of three months. At the end of the first three-month period, the budgets for the remaining three periods should be reviewed and an additional budget prepared for the three months following the year period of the original budget.

**Balance Sheet**

The advertising agency balance sheet is unusual by the absence of investments (securities and real estate) and the inclusion of large borrowings and sizeable cash values of life insurance on officers.

Borrowings and lack of investments go "hand-in-hand" in an advertising agency. Adequacy of working capital is a constant problem. Expenditures for advertising materials tie up working funds, but far more important, daily operation requires sizeable expenditures. The advertising agency income dollar (commissions, fees, percentage charges) is distributed as follows:*

| | Incomes under $100,000 to Incomes over $10,000,000 |
|---|---|
| Salaries ............ | 58-70% |
| Expenses (exclusive of salaries) ........ | 20-34% |
| Net profits before Federal income taxes.. | 5-16% |

It is apparent that in an operation as "close" as this, not only is capital unavailable for investment but temporary borrowings become a necessity. Long-term loans are also required in periods of expansion (a condition ever-present in many agencies).

Life insurance on officers is quite prevalent in advertising agencies. This is a personal service business wherein the owners are generally active participants upon whose efforts the profits depend. The purpose of insuring the lives of principals for the benefit of the agency may be to provide funds to help the agency over a bad period resulting from the death of a principal, or, as is more often the case, to provide funds to buy out the interest of the estate of the deceased. Regardless of how applied, it is a security measure well taken.

**Conclusion**

John Galsworthy once said** "The wish is often mother of the thought." Management sometimes allows its wishes to govern its thoughts. In some businesses, wishful operation, i.e., operation without planning, cost-consciousness, etc., may show profitable results. The advertising agency business is *not* one of these businesses. It is, rather, a business that requires careful planning and skillful operation. Accounting can assist by rendering timely, analytical reports, prepared from economically maintained records.

---

* From the "Fourth Annual Printers Ink Study of Advertising Agency Costs and Operations".

** in his play, "Loyalties"

# The Effect on Taxes and Income of the Diminishing-Balance Method of Depreciation

*By* Alvin Brown

*When, in income tax returns, depreciation can be computed by the diminishing-balance method (as now authorized in Canada), there are three related effects: depreciation is more, taxes are less, and earnings are more, than when depreciation is computed by the straight-line method. These effects occur only once for any asset and its replacements, and are realized in full only over a period of years.*

Doubtless most accountants understand how the accumulation of depreciation reserves in excess of the requirement of renewal causes the aggregate book value of depreciable assets to be reduced to half their cost. This remaining (and permanent) book value is exactly half, although the effect is often obscured by subsequent additions to assets, by inability to forecast the life of assets accurately, and by changes in the price level.

For anyone who may doubt this fact, Table A offers statistical proof. It takes the case of a fleet of 5 trucks, each costing 1, purchased over a period of 5 years, and thereafter replaced at 5-year intervals. Each purchase is made at mid-year, and depreciation in the first year is one-half the annual rate. The table shows how the aggregate net book value is reduced to half of cost at the end of the fifth year. Thereafter, the annual (straight-line) depreciation of 1 always equals the annual cost of replacement, so that net book value remains permanently at half of cost.


Alvin Brown is Vice President for Finance and a Director of Johns-Manville Corporation. He is the author of two books, "Organization: a Formulation of Principle", and "Organization of Industry" and has been a visiting lecturer at Massachusetts Institute of Technology and other colleges.


Of course, where the assets have different lives, so that the amount of replacement varies from year to year, the net book value will vary also. An example of this is too extensive to include in this note, but he who is skeptical can, by his own computation, satisfy himself that, over a sufficient period to average out these variations, the net book value will still become and remain one-half of cost.

Thus, in effect, the excess of accumulated depreciation over the requirement of renewal returns half of the original expenditures. Most enterprises use this recaptured capital to expand their operations, and the effect on net book value is obscured by additions to assets; but nevertheless the conclusion is true of any group of assets that has been owned for one average life.

The Dominion of Canada has authorized use of the diminishing-balance method of depreciation for purposes of income tax. The object of this note is to show how use of this method of depreciation affects book value, depreciation, taxes, and income.

To show the effect of this method, we have used the same facts as in the foregoing example, with a rate of de-

preciation of 40%. Table B shows how annual depreciation, though at the outset it greatly exceeds the straight-line amount, ultimately becomes stabilized at the same amount—which is the requirement for replacement. It also shows how the early excess of depreciation accumulates to reduce the book value, not to one-half the cost (2.5), but to 1.5, or 30% of cost. (The computations were carried to more decimal places, but here rounded off for simplicity.)

Mathematically, the foregoing statement is inaccurate, because the increments of annual depreciation and of remaining book value are infinite. Mathematically, the statement should be that depreciation *approaches* the requirement of renewal (straight-line basis), and that book value *approaches* 1.5. But the statement is accurate enough for practical purposes.

Thus we see that, in this example, the diminishing-balance method recovers a greater part of the cost than the straight-line method does. This greater recovery of cost is at the expense of earnings, however, because the greater reduction in book value is the effect of greater depreciation, and the greater depreciation has reduced earnings *pro tanto* as compared to earnings on the straight-line basis. So the diminishing-balance method has only a "book" effect in taking some of "straight-line earnings" to reduce the stated value of assets.

The amount of this reduction will depend upon the relation between the life of the asset (or average life of the assets) and the diminishing-balance rate. In the example, an arbitrary rate (40%) was used. The Canadian rate for transportation equipment is 30%, but for the more important class of manufacturing equipment it is 20%, regardless of life. If average life is about 20 years, the diminishing-balance rate is four times the straight-line rate, instead of double as in the example.

But the effect on book value can be determined for any life and rate by the following formula:

When C = cost
V = book value at end of year
S = straight-line depreciation rate.
D = diminishing-balance depreciation rate

$$V = \frac{CS(1 - D)}{D}$$

Of course, if the diminishing-balance rate is too low, it will produce less depreciation than the straight-line method. They produce the same amount, and consequently book-value is the same as for straight-line depreciation, when—

$$D = \frac{2S}{1 + 2S}$$

So far, we have found that the diminishing-balance method of depreciation, at rates authorized in Canada, decreases earnings and decreases book value, but causes no change in the amount of money at the command of an enterprise. But at this point a knock on the door warns of the approach of Income Tax, that villain who so often meddles in pure accounting.

Before we receive him, remember that the excess of depreciation by the diminishing-balance method is a *permanent* excess, just as, for the same reason, the reduction in book value is a *permanent* reduction.

Well, this depreciation is a deduction for purposes of income tax. The amount of tax paid is reduced by the amount that results from applying the tax rate to the excess of depreciation. Since the excess depreciation is permanent, so is the reduction in tax.

Of course, a reduction in tax that is permanent—never offset by a subsequent increase—is a permanent addition to income. This is no "book" transfer from earnings to reserve—or vice versa. This is real, money-in-the-till income. The only event that can dissipate it is liquidation of the enterprise.

The general conclusion, therefore, is that, when there is an income tax (need that condition be stipulated?), the diminishing-balance method of depreciation produces more earnings than the straight-line method, though it is a one-time increase and not one that recurs annually.

The formula for the added earnings is as follows:

When E = excess of earnings
T = tax rate
and other symbols are as before—

$$E = \frac{TC\,[D - 2S(1 - D)]}{2D}$$

TABLE A

How Accumulating Straight-Line Depreciation Reduces Net Book Value to One-Half
(Purchases, 1 per year)

| Year | Total Cost | Annual Depreciation | Depreciation Reserve | Net Book Value |
|---|---|---|---|---|
| 1 | 1.0 | .1 | .1 | .9 |
| 2 | 2.0 | .3 | .4 | 1.6 |
| 3 | 3.0 | .5 | .9 | 2.1 |
| 4 | 4.0 | .7 | 1.6 | 2.4 |
| 5 | 5.0 | .9 | 2.5 | 2.5 |
| 6 | 5.0 | 1.0 | 2.5 | 2.5 |

TABLE B

Effect of Diminishing-Balance Depreciation on Net Book Value
(Purchases, 1 per year)

| Year | Basis for Depreciation | Annual Depreciation | Remaining Book Value |
|---|---|---|---|
| 1 | 1.000 | .400 | .600 |
| 2 | 1.600 | .640 | .960 |
| 3 | 1.960 | .784 | 1.176 |
| 4 | 2.176 | .870 | 1.306 |
| 5 | 2.306 | .922 | 1.384 |
| 6 | 2.384 | .954 | 1.430 |
| 7 | 2.430 | .972 | 1.458 |
| 8 | 2.458 | .983 | 1.475 |
| 9 | 2.475 | .990 | 1.485 |
| 10 | 2.485 | .994 | 1.491 |
| 11 | 2.491 | .996 | 1.495 |
| 12 | 2.495 | .998 | 1.497 |
| 13 | 2.497 | .999 | 1.498 |
| 14 | 2.498 | .999 | 1.499 |
| 15 | 2.499 | .999 | 1.500 |
| 16 | 2.500 | 1.000 | 1.500 |

# The Incorporators of The New York State Society of Certified Public Accountants

*This paper gives a brief sketch of the life of each of the incorporators of our Society, and suggests that credit for taking the first steps for its organization should be accorded to the Albany CPA, John Hourigan.*

THE earliest printing of the Certificate of Incorporation under which the State Society was organized—or at least the earliest that has been found by the Committee on History—was that on pages 5-7 of the 1907 Year Book which was published sometime after May 10, the latest date in the book. As there printed, the Certificate was dated January 28, 1897, and bore the signatures of John Hourigan, S. Eugene Sargent, Francis Gottsberger, Farquhar J. MacRae and Henry Harney, and stated that they were to be the directors until the first annual meeting of the Society.

Questions which naturally come to mind at once are: By whom were the five Incorporators selected for this service? Who were these Incorporators who were to be Directors? What were their qualifications for service in such capacities? Two letters printed in the *Financial Record* of January 13, 1897, may serve as a basis for a search for answers to the questions.

An article in the May, 1949, issue of *The New York CPA* told of what seemed to have been the earliest movement for the Society. For those who may not have preserved that magazine it may be sufficient to state that it quoted from *Financial Record* a copy of a letter which John Hourigan had sent all the CPAs in which he suggested the desirability of an association and proposed that on some convenient date a meeting be held to consider his suggestion. The date of his letter was not given in the *Record*. But it must have been after December 1, the date of the earliest certificates, and before January 11, the date when Frank Broaker, Vice President of the American Association of Public Accountants, issued a letter in opposition to Hourigan's suggestion.

Whether the proposed meeting was held has not been learned. Even if held, only two who could have attended are still living. Paul A. Hourigan does not have any of his father's papers. And William J. Nusbaum who was with John Hourigan 10 years from 1902 is "sure that all his files were destroyed years ago."

However enough of the replies to Hourigan's letters may have been favorable to his suggestion for him to decide not to wait for his proposed meeting, but to proceed with incorporation before Broaker's opposition might cause some to hesitate. He had started the movement and probably wished to carry it through. And if time seemed important to him—as the execution of the Certificate only 17 days after the date of Broaker's letter suggests—he may have decided to select the Incorporators himself. If so that gives the answer to the first of the three questions.

It is such common practice to take up a group of names in alphabetical sequence—or in the order of seniority—by either of which Gottsberger, like Abou Ben Adhem, would have led all the rest—that both arrangements were

> This is the tenth in a series of articles on the History of Accounting in the State of New York. It was prepared by the Society's Committee on History.

here considered. But since the sequence of the signatures may have been planned, not accidental, the Incorporators are here briefly considered in the order of their signatures. For each a brief sketch of his life to the end of 1896 is given with such later facts as may seem to indicate his qualifications and why he was chosen for this service.

### John Hourigan

John Hourigan was born in Albany on February 22, 1854, and therefore was nearly 43 years of age at January 25, 1897. His formal education was with the Christian Brothers in Albany and that he supplemented by serious private study. His business life started in the Home Savings Bank of Albany. It seems that while there employed he was interested in banking methods, for the January, 1889, issue of *The Office* (Vol. 6, p. 14) printed his letter of November 15, 1888, relative to Savings Bank Balances and describing his plan for getting correct ones.

The next year, 1889, he organized the Safety Building Loan Savings Institution and was its Secretary many years. In that connection he published in 1894, "Maturity Tables for Building and Loan Associations and other purposes."

In 1890, he resigned from the Bank to devote all his time to public practice. Probably he had practiced part-time before 1890, for the *Financial Record* of October 15, 1897, stated: "He has been practicing as a public accountant for seventeen years."

And while this brief survey of his activities has shown that he was interested in accounting principles and procedures, it is certain that he was also interested in his profession as a whole. At that time there were only two societies of accountants in the State of New York, the Institute of Accounts organized in 1882 and the American Association of Public Accountants in 1886. The title page of his book, published in 1894, shows him as a Fellow of the earlier society. When he became a member of it has not been learned but various references suggest that it was probably before 1890, perhaps in the middle 1880's.

In his younger days he was an enthusiastic oarsman at a time when shells and outriggers were popular on the river. During many years he was the only public accountant in Albany. He was prominent in the community and his church but he never held civic or sectarian office.

Besides the abilities and experience here mentioned there was another activity which may have been an additional qualification for leadership in the formation of the State Society. While there is no record of his having participated in the drafting of either of the CPA bills which were introduced in the 1895 Legislature, he was actively engaged in that effort only a little later.

On March 13, 1895, he attended the meeting in New York when 45 accountants were present including about 20 to 25 members of the American Association of Public Accountants, 7 to 10 of the Institute of Accounts and some not members of either society. A Committee of 14—so called—was created to look after the matter. According to the official record of that meeting Hourigan was not a member of that committee, though in a paper which George Wilkinson read at the Pittsburgh meeting of the American Society of CPAs on September 29, 1927, he listed John E. Hourigan (sic) as one of the non-member group. But Wilkinson was not present at the 1895 meeting and used second-hand information. Perhaps his statement was based directly or indirectly upon a story in *Business* of July, 1896 (Vol. 16, p. 289) which mentioned the efforts made by various individuals and stated: "The Institute was thus represented by its member resident in Albany."

But while the editor of *Business* acknowledged the help given by Hourigan without specifically naming him, merely indicating him by the phrase

"its member resident in Albany," the Chairman of the Committee of 14 was explicit and moved:

> "That this Association extends its thanks to Mr. John Hourigan of Albany, Public Accountant, for his services and support in the attempt to pass an act to regulate the profession of Public Accountants, and the Secretary is hereby directed to forward a copy of this resolution to Mr. Hourigan."

The resolution so moved was adopted by the American Association at a meeting on October 8, 1895 (2 Minutes 71).

At the next meeting of the Association Trustees, October 24, there was read a letter from John Hourigan dated October 10,

> "suggesting a meeting of accountants representing different sections of the State in November soon after the election for the purpose of agreeing upon the text of the bill and to select the right Assemblyman and Senator to take charge of the matter when presented." (2 Minutes 74)

The records in 1896 do not mention John Hourigan as often as previously, perhaps because the Association's Vice President Frank Broaker was in Albany almost continuously. But in the July 18, 1896, issue of the *Financial Record* it was stated that Francis Gottsberger—who was Chairman of the Committee of 14—and W. Sanders Davies—who was a member of the Committee—called for Hourigan to accompany them for a conference with James Russell Parsons, Jr., director of the Examination Department of the University. Evidently he was still useful.

This brings his story to the formation of the State Society. Later he was an officer of the Institute of Accounts as well as of the State Society. He retired from practice about 1916 at the age of 62 and died July 17, 1932, at 78.

### Sidney Eugene Sargent

Sidney Eugene Sargent was born in 1857, date and place not learned. He came to New York in 1880 and his name appeared for the first time in the New York City Directory of 1897. But it had been shown in three places in 1896. The October issue of *Business* (Vol. 16, p. 443) carried an article copyrighted by him on "How We Will Stand with Free Silver Coinage at 16 to 1." The August issue had on page 383 a list of about 125 public accountants and firms, which showed him as located at 514 Broadway, though his name was not in the similar lists in the June and July issues. And in 1896 CPA certificate #28 was issued to him, it being issued in the second group. And for that recognition he must have shown the Board of Examiners that he had been practicing during 5 years, or since April 1890 or earlier.

The April, 1897, issue of *Accountics* (Vol. 1, p. 14) showed that on April 1 he was elected to the Executive Council of the National Institute of Accounts. He became a charter member of the New York State Society in March, 1897, and through that he came into the American Association of Public Accountants in 1905. In 1897 also he was a charter member of the National Society of Certified Public Accountants. *Business World* of February, 1901, mentioned his removal from 380 Broadway to 85 White Street. And from 1907 the Year Books of the State Society and American Association show him located at 41 Park Row to 1919, and thereafter at 201 West 79 Street, presumably his residence in the Hotel Lucerne. There is no record of his having partners—apparently he practiced alone.

He died in New York February 21, 1932.

### Francis Gottsberger

Francis Gottsberger was born in New York July 30, 1833, and therefore was 63½ years of age at January 28, 1897. He was educated at the Old Columbia College Grammar School. His business experience was largely in merchandising and for a considerable period he acted as buyer for large mercantile houses in New York and Boston. While probably he was not the bookkeeper, he came to understand that work. He was listed as a public ac-

countant in the New York City Directory of 1884, but a sketch in the Financial Record of October 15, 1897, stated that he had been in active practice 15 years, or from 1882. That article also stated that "from the first he made a specialty of Surrogate's accounts." As a result of that experience he published in 1902 "An Accountants Guide for Executors, Administrators, Assignees, Receivers and Trustees."

Apparently he did not join the Institute of Accounts but he became a Fellow of the American Association of Public Accountants on September 15, 1893. Only 4 months later he was elected a Trustee, on January 27, 1894, and 2 years later, on January 14, 1896, he was elected Treasurer.

Without any collaboration he drafted an accountancy bill which he read to the Association February 12, 1895, after he had sent it to Senator Daniel Bradley for introduction in the Legislature. The records do not show that he had been asked to draft the bill and his action seems to have been a surprise to the Association, which, however, at that meeting made him Chairman of the Committee on Legislation.

When the Gottsberger bill collided in the Legislature with one sponsored by the Institute of Accounts, he with W. Sanders Davies issued a call to all public accountants in New York to attend a meeting on March 13, 1895. At this joint legislative meeting he was chosen as Chairman and then also Chairman of the Committee of 14, which against his wishes decided to support the Institute bill.

In 1896, the Vice Chairman of the Association Committee on Legislation, Frank Broaker, who was also Vice President of the Association, took such active steps for the bill that Gottsberger was less prominent, perhaps also less active. Only two references to him in that year have been found. In July he with W. Sanders Davies called for Hourigan to go with them for a conference with the Director of Examinations. And he became CPA #36 in the third group issued. On January 7, 1897, he wrote resigning as Trustee and Fellow of the Association.

He was a Charter Member of the State Society and served it 6 terms as Director and 4 terms as Vice President. He wrote papers on financial and accounting subjects for periodicals. In 1897 he, with Farquhar J. MacRae and John R. Loomis, organized the Certified Public Accountants Company, which however was not listed in the New York Directory and may not have engaged in practice. In 1902 he won a suit for services for which the client had refused to pay more than one-half of the accountant's fee.

He died November 24, 1913, and by his will left $100,000 to his church.

### Farquhar J. MacRae

Farquhar J. MacRae was born in Brooklyn April 8, 1862, and was not yet 35 years of age when he signed as Incorporator. He was educated at Erasmus Hall Academy in Brooklyn. Prior to beginning practice on his own account he had been with Howard Bartlett & Co., Selden R. Hopkins and Henry Harney. He was first listed as a public accountant in the New York Directory of 1892 but a sketch in the *Financial Record* of October 15, 1897, stated that he had been in practice for ten years, so that it seems that he began in 1887 or earlier. Early in 1894 he had John D. Cowan with him as MacRae & Cowan. This firm advertised for assistants, offering $40 per week to those who had five years experience and were members of the Institute of Accounts and only $20 per week to English CAs who "had sufficient experience in this country to render them familiar with modern methods of bookkeeping." This was inspired by William Waddell's help-wanted notices. Later his firm was MacRae, Gardner & Co. with J. A. S. Gardner as his partner, but that was dissolved early in 1897, after which the firm name was Farquhar J. MacRae & Co. In 1897, with Gottsberger and

John R. Loomis, he participated in the organization of the Certified Public Accountants Company, with an authorized capital stock of $10,000 par value, which it seems did not continue in practice long if at all.

He joined the Institute of Accounts in 1890 or earlier, had become its Secretary by July, 1892, and was advanced to Fellow on November 9, 1893. On April 1, 1897, he was elected to the Executive Council of the National Institute, and on May 18, 1899, he was in Hartford when that chapter was formed.

He received CPA certificate #23 in the second group issued in 1896, and after signing as an Incorporator of the State Society he became a Charter Member in March, 1897. He was elected a Director in 1897 and 1898, a Vice-President four times beginning in 1899, was elected President on January 17, 1903, for the vacancy resulting from the death of Charles W. Haskins and was reelected three times in 1903, 1904 and 1905.

On February 5, 1903, he became President of the Federation of Societies of Public Accountants in the United States, but resigned on June 17, 1904, following the withdrawal of the New York State Society from the Federation. As President of the State Society he, with President Loomis of the American Association of Public Accountants, presided as co-chairman at the dinner on October 4, 1904, which the two organizations gave for the foreign delegates to the Congress of Accountants at the St. Louis World's Fair.

At the age of 85, he died in Brooklyn, March 4, 1947.

### Henry Harney

Henry Harney was born in Baltimore, probably about 1835. His early education was by his father E. Rhodes Harney, head of Franklin Square Female Seminary, and in private schools. Later he attended the Baltimore College, University of Maryland. His business experience in Boston, in a large commercial house in Richmond, and as Chief Accountant in the Bank of Richmond, may have covered about 5 years, 1856 to 1861. During the Civil War he served in the 1st Virginia Regiment and was advanced to a captaincy. MacRae wrote that Harney's northern civilian friends promoted him to a major. He came to New York after the War and during a part of the next 25 years was with Joseph Steiner & Company, a tea house.

He began public practice in 1890 apparently alone, but later as Harney, Cady & Co., Harney, Scott & Co., Henry Harney & Co., having as partners at various times, Charles E. Cady, Herbert W. Hills, William E. Kastendike, John Kastendike, Wilbur A. D. Scott, Edward Glardon, Sylvester E. Strickland and William Cockcroft.

He became a member of the Institute of Accounts in 1886 and a short time later was elected Secretary and, still later, served five successive terms as its president. He was a member of its committee which prepared its CPA bill; perhaps he prepared the first outline for it. He attended the joint legislative meeting on March 13, 1895, and was elected to the Committee of 14 and to its subcommittee of 5. He received CPA certificate #18 in the second group issued, and became a Charter Member of the State Society in March, 1897, but resigned December 14, 1899. He continued his activity in the Institute of Accounts to his death on May 19, 1910.

The foregoing has shown that John Hourigan was active in the efforts to obtain the enactment of a CPA Law; that he suggested the formation of an association of CPAs; that he assumed or was granted the leadership for a society; that probably he believed haste was important because of the opposition by Broaker, Vice President of the Association; that he had many acquaintances in the Institute of Ac-

(Continued on page 232)

# New York State Tax Forum

*Conducted by* BENJAMIN HARROW, C.P.A.

**Franchise Tax—Allocation**

A New York corporation did business within and without the state. It had both a regular place of business and a permanent and continuous place of business outside the state. It was therefore entitled to a complete allocation of its income. In fact only about 11% of its income was taxable in New York, since most of its activities were carried on outside the state. The corporation sold its business and disposed of all of its assets. The sale qualified as an installment transaction and the corporation so reported it under the Internal Revenue Code. Its only asset after the sale consisted of notes receivable representing the balance due on the sale. During the year in issue when the only activity of the corporation was the collection of the notes, could the corporation allocate any of the income on the installment sale?

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Each year must be considered by itself in determining the right to allocate income. The allocation percentage changes from year to year, the activities of each year determining both the right to allocate and the extent to which the allocation factors will determine the degree to which income will be allocated to New York or outside of New York.

Apparently, after the corporation in question disposed of its assets it no longer had either a regular place of business outside the state, which would entitle it to an allocation of its inventory, or a permanent and continuous place of business which would entitle it to an allocation of its receipts. Since it had no place of business outside the state after the sale, it is not entitled to any allocation on receipts of income from the installment sale, even though in the previous year only 11% of its income was taxable in New York.

A corporation in receipt of investment income may allocate its income even though it has no office outside the state. This provision in the law would not be helpful to the corporation under discussion since it had no investment capital which would entitle it to an allocation. Investment capital is defined as investments in corporate and governmental securities not held for sale to customers in the regular course of business, exclusive of subsidiary capital. Notes receivable are not within the scope of the definition of securities.

There is left the possibility that the sale of the corporate assets might be reported for franchise tax purposes in the year of sale as a completed transaction, rather than as an installment sale even though it was so reported for federal tax purposes. We are mindful

of the fact that net income for franchise tax is presumably the same as net income for federal tax purposes. But it might be argued that net income as reported federally does not properly reflect the true net income of the corporation. If the Tax Commission agreed with the taxpayer it could allow the transaction to be reported as a completed one in the year of the sale.

### Estate Tax—Nature of the Tax

Both the federal government and the state tax the transfer of property at death. The tax accrues whether the law is so worded as to tax the right to transmit the property at death or the right to receive such property at death. The distinction is no longer material. While death is the generating source of the tax, the tax embraces certain transfers of property that a decedent may have made during his lifetime. This has been sanctioned by the courts on the theory that such lifetime transfers are in some vital way associated with death and are in essence testamentary in nature. Courts have found it necessary to cut through traditional concepts of property and property rights in taxing such lifetime transfers at death in order to prevent the circumvention of death tax laws and to safeguard the revenues.

Dower rights which are inchoate upon marriage have long been included in the gross estate as rights which ripen only at death (Sec. 249(r)(2)) and therefore are testamentary in nature and so subject to the estate tax.

Joint tenancies have been the subject of much litigation but it is fairly well settled that the gross estate includes the value of a decedent's full interest in property as a joint tenant. The fact that another person may have a legal interest in the same property is of minor importance. Only that part of the property that is shown to have originally belonged to the other person is excluded from the gross estate. For example, a bank account in the names of a decedent and a spouse would be taxed in the full amount in the decedent's estate even though the wife has a legal interest in the account, could have drawn on the account during decedent's lifetime, and acquires the entire account by right of survivorship. (Sec. 249-r(6))

A tenancy by the entirety is a form of joint estate where the owners are husband and wife. Their interests in the property are undivided, but the entire property would be taxed to the estate of the one who died first except such part as is shown to have belonged originally to the survivor. If the property held by a husband and wife in the entirety has been acquired by gift or inheritance it is taxable to the extent of one-half the value. (Sec. 249-r(5))

### Transfers to Take Effect in Possession or Enjoyment at or After Death

To tax something at death that a decedent does not then own is a rather novel idea for a lawyer, as well as a layman, to accept and he has not done so without an unremitting struggle. But the courts have now definitely sanctioned the principle that any transfer of property made by a decedent at any time during his life, by trust or otherwise, may be taxed at death if the decedent, though parting with the legal title has retained the possession of the property, the enjoyment of the property, the right to the income from the property or the right alone or with any person to designate those who shall possess or enjoy the property or the income. If he has retained none of these powers, the estate will still be taxed on a transfer of property during life if the possession or enjoyment of property can be obtained *only* by surviving the decedent.

One device for transferring property is the revocable trust. The grantor transfers the legal title to property in trust, but he retains a power to alter, amend, revoke or terminate it. If the power exists on the date of death of the grantor then the transfer was of a testa-

mentary nature and the property so transferred would be taxed at death.

The irrevocable transfer in trust may sound more invulnerable to the death tax then the revocable transfer, but it too is drawn into the tax net if in some way the transfer may be said really to take effect at death. For example, even though the trust is irrevocable the grantor may have retained a power to modify it or to change beneficiaries or there may even be a possibility that the property might revert to the grantor under certain conditions. The tax arm will embrace such a transfer. Since only the death of the grantor eliminates these powers, the value of the property is taxed at death.

## Power of Appointment

In recent years this power has acquired a special significance because a life estate coupled with a power of appointment qualifies for the marital deduction. Briefly, it is a right given to a person to designate who is to receive certain property at some future time. The most common use of the power of appointment is in connection with a transfer of legal title to property to a trustee wherein the grantor gives a life estate in the trust fund to W and further provides that W may name those who are to take the property after the life estate.

The law includes in the gross estate any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942. A general power is one which is exercisable in favor of the decedent, his estate, his creditors or the creditors of the estate. If the general power of appointment was created on or before October 21, 1942, it will be taxed in the estate of the person possessing the power only if the power is exercised. If the power was created after October 21, 1942, the mere possession of it at death subjects it to the estate tax. To avoid the tax on the property subject to the power the donee must renounce or disclaim it when the power first comes to his attention or release it absolutely.

## Federal Changes in Net Income

Effective July 1, 1949, the state income tax law requires a taxpayer to report a change or correction in net income made by the federal government. This must be reported within 90 days of a final determination. (Sec. 367(2)) The Tax Commission must assess any additional tax due within one year after written notice of such change. (Sec. 373(4))

By a recent regulation (Art. 57(a)) notification of a change must be made on a special form (IT-115). If the change results in a refund the form must be accompanied by a copy of the final determination. If additional tax is due the details of the changes must be indicated on form IT-115 and the copy of the final determination need not be submitted. The tax must be paid with the filing of the return.

The filing of an amended return with the Treasury Department requires the filing of a similarly amended return with the Tax Commission within 90 days.

A change in federal net income extends the limitation period for assessing an additional tax and likewise extends the period for refunds. The regulation adds that no refund will be made unless the Tax Commission receives notification of the change within the prescribed time. The Tax Commission also reminds us in the regulation that it is not required to accept as correct the reported change but may make its own independent investigation.

The regulation defines a final determination as an irrevocable determination from which there exists no further right of appeal. Included in the illustrations of a final determination is the assessment of a deficiency pursuant to a waiver under Section 272(d) where no 90-day deficiency notice is issued.

### Deductions—Use of a Home as an Office

Ordinary and necessary expenses are deductible from gross income, while personal expenses are not deductible. Where the home is also used as an office, expenditures may be partly business expenses and so deductible, and partly personal and not deductible.

This situation has come before the Tax Court.[1] In the *Newman* case, a liquor manufacturer's representative maintained an office in his apartment. Business mail and telephone calls came to his home and also business callers. Newman had a desk, a filing cabinet and other office equipment in his home. He was allowed to deduct a portion of his rent, some redecorating expenses, and even salary paid to his wife for secretarial work as ordinary and necessary expense of his business.

Doctors and lawyers who conduct their practices from their homes have little difficulty in proving ordinary and necessary expenses. The business man who uses his home as an office is subject to the same rules. To prove that the home is being used as an office, the taxpayer should have some physical evidence of an office, such as a filing cabinet, a desk and a chair. If business mail is directed to the house, the envelopes should be retained as evidence. A diary containing a record of business visitors is helpful evidence.

All ordinary and necessary expenses in maintaining the office at home are deductible, including heating, lighting and a portion of the rent or depreciation on a portion of the home if the taxpayer owns it. The same rules would apply under the state income tax law.

### Tax Advantages at Age 65

Under the Internal Revenue Code a taxpayer who reaches the age of 65 obtains certain tax advantages. First, he is entitled to an additional exemption of $600. This provision covers also the personal exemptions for a spouse 65 years of age. It should be noted that no additional exemption is allowed for a dependent who is over 65. A spouse is not a dependent for this purpose. The New York income tax law does not presently contain any similar provision of an additional exemption because of 'old' age. However the personal exemption for a husband and wife is $2,500, which is still $100 more than the personal exemption of a husband and wife under the Internal Revenue Code even if both spouses were 65 years of age.

The second tax advantage under the Internal Revenue Code for a taxpayer 65 years of age is the elimination of the 5% test for the medical expense deduction. All medical expenses become deductible for such taxpayers up to the maximum limitations. Medical expenses for dependents are still deductible but only to the extent that they exceed 5% of adjusted gross income.

The New York law does not presently have any similar provision for taxpayers 65 years of age. On a joint return only such medical expenses as exceed 5% of net income are deductible with the maximum deduction limited to $1,500.

### Deduction for Taxes

One of our members questions the correctness of a ruling that taxes assessed on furs, cosmetics, jewelry and automobiles are not deductible by the ultimate purchaser and requests our opinion. Art. 141 of the regulations provides in part that

> "taxes imposed by the federal revenue act or by the statutes of any other jurisdictions upon sales, services or facilities are not deductible, *even though billed as separate items,* unless under the provisions of such statutes the tax is expressly imposed against the taxpayer." (Emphasis supplied.)

The federal excise taxes assessed on furs, cosmetics, jewelry and automobiles are levied against the sellers. Sections 2400, 2401 and 2402, of the

[1] *Newman,* TC Memo — Docket No. 28955.

I.R.C. impose the retailers excise taxes on jewelry, furs and toilet preparations. Section 2403 reads:

> "Every person who sells at retail any article taxable under this chapter shall make monthly returns *and pay the taxes imposed by this chapter.*" (Emphasis supplied.)

This language would appear to impose the tax upon the retailer who sells the specified articles to the ultimate consumer.

If the retailer passes the tax on to the ultimate consumer, he is really charging that much more for the property he sells. Cabaret taxes and admission taxes are deductible because they are levied directly on the person who seeks admission. The ruling of the Income Tax Bureau would appear to be correct.

### Estate Tax—Life Insurance Proceeds

A decedent in 1935 at age 62 had purchased two separate insurance contracts. One was a single premium annuity policy under which the insurer was to pay the insured about $1,600 annually for life. The other was a life insurance policy in the face amount of $72,000 issued without medical examination for which a single premium of about $54,000 was paid. The insurance company would not have issued one policy without the other. The decedent assigned the life insurance policy to her children, retaining no rights in the policy. The decedent paid a gift tax on the gift of this policy.

The decedent died in 1942. The life insurance proceeds were not included in the gross estate for estate tax purposes, but the Commissioner assessed a tax on the theory that both contracts were really one. The transfer of the life insurance contract was really a transfer with a retention of income for life, this being represented by the annual payment on the annuity contract. Both the District Court and the Circuit Court held for the estate[2] overruling the Commissioner.

This is an interesting decision since the Supreme Court had held that the combination of a single premium annuity-insurance policy was not "within the definition of insurance and so not excluded from the gross estate under a former revenue act."[3] The cases seem to be distinguishable only because the instant case was based upon two separate contracts. Said the court, "They constituted independent units, two pieces of property." The court placed no legal significance upon the fact that the life insurance policy would not have been issued without the annuity. On the contention that the annuity payments constituted income from the insurance policy, the court said that the annuity was bought and paid for separately just as was the life insurance policy. No part of the latter contributed to the annuity.

A strong dissenting opinion leads this writer to the conclusion that the Supreme Court will probably overrule this decision. If not, a way has been found to overcome the effect of the *Le Gierse* case. It will be possible to purchase life insurance at an advanced age, without medical examination, tying it in with the purchase of an annuity, and by making a gift of the insurance policy avoid the inclusion of the life insurance proceeds in the taxable gross estate.

### Correction:

*Gross Receipts Tax—Dealers in Merchandise.* In the February 1953 issue we stated that if the spread between selling price and cost of goods sold is more than 3% and not in excess of 5%, the tax is at the rate of 1/10 of all New York receipts. This, of course, should have read 1/10 of 1%.

---

2 *Estate of Mary A. Bohnen* v. *Harrison,* C. A., 7th Circuit, Oct. 29, 1952.

3 *Helvering* v. *Le Gierse,* 312 U. S. 531 (1941).

# Payroll Tax Notes

*Conducted by* Samuel S. Ress

## Social Security and Federal Income Taxes

To claim an exemption for a relative receiving social security benefits, these conditions must be satisfied:

(1) The person supported must have received less than $600 in gross income, exclusive of the social security benefit received. Any amount received as a benefit pursuant to the provisions of the social security law whether as a survivor's benefit, a death benefit, or an old-age benefit, is not taxable income for federal income tax purposes.

(2) The dependent must be a close relative, as defined in the Internal Revenue Code, and the recipient of more than one-half of his support from the person who claims the dependent. However, in figuring whether or not more than one-half of the dependent's support has been provided by the taxpayer to the dependent, amounts received as social security benefits and used for support by the dependent, must be considered.

Samuel S. Ress has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

## Wage and Salary Controls Ended

Despite the removal of wage and salary controls on February 6th, 1953, pursuant to the executive order issued by President Eisenhower, violators of the wage and salary control laws in the past may be prosecuted and subject to the penalties provided in the law while it was in effect.

Accountants should notify their clients not to destroy their wage and salary stabilization records and files. Be sure to save all records of pay adjustments, wage and salary schedules, descriptions of job classifications, etc. Preserve all letters of approval by the Wage Stabilization or the Salary Stabilization Board. They may be needed to support wage and salary income tax deductions on the occasion of an internal revenue agent's examination on a later date.

It should be especially noted that provision was made in the order for continued authority to enforce penalties for past violations of these orders and regulations. It does not rescind modifications or denials of adjustments in previous petitions. However such adjustments can be put into effect for the future without being subject to the penalty which could have been imposed had the adjustment been put into effect in the period prior to February 6th, 1953.

If any petition was pending at the time of the executive order it can be put into effect just as if approval had been granted as of the date of the petition.

The order sanctions adjustments made in union contracts which were to have been put into effect upon approval by the Board.

# Office and Staff Management

**A forum for the exchange of views and information on all aspects of the administration of an accounting practice.**

*Conducted by* MAX BLOCK, C.P.A.

### New Federal Rule for Corporation Tax Extensions

Extensions for filing corporation tax returns may be requested by accountants in behalf of their clients, without having a power of attorney for that purpose. The accountants must, however, be enrolled practitioners of the U. S. Treasury Department. One letter may be used to apply for extensions for several companies.

The request must contain, in addition to the reasons for the extension, the following statements:

1. The request is made with the knowledge and consent of the taxpayer.
2. The accountant is an enrolled practitioner.

Tentative returns need no longer be submitted in connection with requests for extension of time for filing Federal income tax returns. Instead, it is only necessary to file Form 7004—Statement in Lieu of Tentative Return of U. S. Corporation Income Tax signed by two corporate officers or by an enrolled practitioner of the U. S. Treasury Department, without need for a power of attorney.

If you cannot obtain blanks of Form 7004, make up your own typed or mimeographed copies. They will be accepted. (I.R. Mim. 128, 2/9/53.)

The estimated first installment of the tax must be remitted with Form 7004.

MAX BLOCK, C.P.A. (N.Y., Pa.) is a director of the New York State Society of Certified Public Accountants and has been the Chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

### Partnership Tax Decision

In the January, 1953, issue of this column there was a reference to an important decision (*Carol F. Hall,* 19 TC-No. 57) involving the interpretation of an accounting firm's partnership agreement. The retirement and death clauses were involved, and the question of good will was discussed in the decision.

This department has been informed that the two retired partners, who were adversely affected by the decision, are proceeding with an appeal to the United States Circuit Court of Appeals.

### Reproductions of Tax Returns—Note of Caution

Accountants who are, and who contemplate, using machines for the reproduction of handwritten or typed returns for filing with the Treasury Department have a special responsibility. It is to make sure that the photographic copies are in very good condition as to legibility and cleanliness.

If the Treasury should find that too many handwritten returns are illegible, or that the reproductions are faint, there is a danger that the permission to file this type of copy will be revoked. Great care must be exercised to avoid such an event, even if it requires rewriting or re-reproducing one or more returns.

### Reproduction of New York State Tax Returns

Though the Society was unsuccessful in its attempt to obtain from the State Tax Commission similar reproduction privileges as were granted by the Commissioner of Internal Revenue, continued efforts will be made to accomplish this objective.

# OFFICIAL DECISIONS *and* RELEASES

## ACCOUNTING RESEARCH BULLETINS

**No. 37 (Revised)** **January, 1953**

### Accounting for Compensation Involved in Stock Option and Stock Purchase Plans

Issued by the

COMMITTEE ON ACCOUNTING PROCEDURE,
AMERICAN INSTITUTE OF ACCOUNTANTS,

270 Madison Avenue, New York 16, N. Y.

*This bulletin supersedes Accounting Research Bulletin No. 37, "Accounting for Compensation in the Form of Stock Options," issued in November, 1948.*

### Introduction

1. The practice of granting to officers and other employees options to purchase or rights to subscribe for shares of a corporation's capital stock has been followed by a considerable number of corporations over a period of many years. To the extent that such options and rights involve a measurable amount of compensation, this cost of services received should be accounted for as such. The amount of compensation involved may be substantial and omission of such costs from the corporation's accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given in this bulletin to the accounting treatment of compensation represented by stock options or purchase rights granted to officers and other employees.[1]

2. For convenience, this bulletin will discuss primarily the problems of compensation raised by stock option plans. However, the committee feels that substantially the same problems may be encountered in connection with stock purchase plans made available to employees, and the discussion below is applicable to such plans also.

### Rights Involving Compensation

3. Stock options involving an element of compensation usually arise out of an offer or agreement by an employer corporation to issue shares of its capital stock to one or more officers or other employees (hereinafter referred to as grantees) at a stated price. The grantees are accorded the right to require issuance of the shares either at a specified time or during some determinable period. In some cases the grantee's options are exercisable only if at the time of exercise certain conditions exist, such as that the grantee is then or until a specified date has been an employee. In other cases, the grantees may have undertaken certain obligations, such as to remain in the employment of the corporation for at least a specified period, or to take the shares only for investment purposes and not for resale.

### Rights Not Involving Compensation

4. Stock option plans in many cases may be intended not primarily as a special form of compensation but rather as an important means of raising capital, or as an inducement to obtain greater or more widespread ownership of the corporation's stock among its officers and other employees. In general, the terms under which such options are granted, including any conditions as to exercise of the options or disposal of the stock acquired, are the most significant evidence ordinarily available as to the nature and purpose of a particular stock option or stock option plan. In practice, it is often apparent that a particular option or plan involves elements of two or more of the above purposes. Where the inducements are not larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital, no compensation need be presumed to be involved.

5. Stock purchase plans also are frequently an integral part of a corporation's program to secure equity capital or to obtain widespread ownership among employees, or both. In such cases, no element of compensation need be considered to be present if the purchase price is not lower than is reasonably required to interest employees generally or to secure the contemplated funds.

[1] Bulletin 37, "Accounting for Compensation in the Form of Stock Options," was issued in November, 1948. Issuance of the present bulletin and its expansion to include stock purchase plans was prompted by the very considerable increase in the use of certain types of option and purchase plans following the enactment in 1950 of Section 130A of the Internal Revenue Code. This section granted specialized tax treatment to employee stock options if certain requirements were met as to the terms of the option, as to the circumstances under which the option was granted and could be exercised and as to the holding and disposal of the stock acquired thereunder. In general, the effect of Section 130A is to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of such restricted options. In 1951, the Federal Salary Stabilization Board issued rules and regulations relating to stock options and purchase rights granted to employees whereby options generally comparable in nature to the restricted stock options specified in Section 130A might be considered for its purposes not to involve compensation, or to involve compensation only in limited amounts.

**Time of Measurement of Compensation**

6. In the case of stock options involving compensation, the principal problem is the measurement of the compensation. This problem involves selection of the date as of which measurement of any element of compensation is to be made and the manner of measurement. The date as of which measurement is made is of critical importance since the fair value of the shares under option may vary materially in the often extended period during which the option is outstanding. There may be at least six dates to be considered for this purpose: (a) the date of the adoption of an option plan; (b) the date on which an option is granted to a specific individual; (c) the date on which the grantee has performed any conditions precedent to exercise of the option; (d) the date on which the grantee may first exercise the option; (e) the date on which the option is exercised by the grantee; and (f) the date on which the grantee disposes of the stock acquired.

7. Of the six dates mentioned two are not relevant to the question considered in this bulletin—cost to the corporation which is granting the option. The date of adoption of an option plan clearly has no relevance, inasmuch as the plan per se constitutes no more than a proposed course of action which is ineffective until options are granted thereunder. The date on which a grantee disposes of the shares acquired under an option is equally immaterial since this date will depend on the desires of the individual as a shareholder and bears no necessary relation to the services performed.[2]

8. The date on which the option is exercised has been advocated as the date on which a cost may be said to have been incurred. Use of this date is supported by the argument that only then will it be known whether or not the option will be exercised. However, beginning with the time at which the grantee may first exercise the option he is in effect speculating for his own account. His delay has no discernible relation to his status as an employee but reflects only his judgment as an investor.

9. The date on which the grantee may first exercise the option will generally coincide with, but in some cases may follow the date on which the grantee will have performed any conditions precedent to exercise of the option. Accordingly this date presents no special problems differing from those to be discussed in the next paragraph.

10. There remains to be considered the date on which an option is granted to a specific individual and the date on which the grantee has fulfilled any conditions precedent to exercise of the option. When compensation is paid in a form other than cash the "amount" of compensation is ordinarily determined by the fair value of the property which was agreed to be given in exchange for the services to be rendered. The time at which such fair value is to be determined may be subject to some difference of opinion but it would appear that the date on which an option is granted to a specific individual would be the appropriate point at which to evaluate the cost to the employer, since it was the value at that date which the employer may be presumed to have had in mind. In most of the cases under discussion, moreover, the only important contingency involved is the continuance of the grantee in the employment of the corporation, a matter very largely within the control of the grantee and usually the main objective of the grantor. Under such circumstances it may be assumed that if the stock option were granted as a part of an employment contract, both parties had in mind a valuation of the option at the date of the contract; and accordingly, value at that date should be used as the amount to be accounted for as compensation. If the option were granted as a form of supplementary compensation otherwise than as an integral part of an employment contract, the grantor is nevertheless governed in determining the option price and the number of shares by conditions then existing. It follows that it is the value of the option at that time, rather than the grantee's ultimate gain or loss on the transaction, which for accounting purposes constitutes whatever compensation the grantor intends to pay. The committee therefore concludes that in most cases, including situations where the right to exercise is conditional upon continued employment, valuation should be made of the option as of the date of grant.

11. The date of grant also represents the date on which the corporation foregoes the principal alternative use of the shares which it places subject to option, i.e., the sale of such shares at the then prevailing market price. Viewed in this light, the "cost" of utilizing the shares for purposes of the option plan can best be measured in relation to what could then have been obtained through sale of such shares in the open market. However, the fact that the grantor might, as events turned out, have obtained at some later date either more or less for the shares in question than at the date of the grant does not bear upon the measurement of the compensation which can be said to have been in contemplation of the parties at the date the option was granted.

[2] This is the date on which income or gain taxable to the grantee may arise under Section 130A. Use of this date for tax purposes is doubtless based on considerations as to the ability of the optionee to pay taxes prior to sale of the shares.

### Manner of Measurement

12. Freely exercisable option rights, even at prices above the current market price of the shares, have been traded in the public markets for many years, but there is no such objective means for measuring the value of an option which is not transferable and is subject to such other restrictions as are usually present in options of the nature here under discussion. Although there is, from the standpoint of the grantee, a value inherent in a restricted future right to purchase shares at a price at or even above the fair value of shares at the grant date, the committee believes it is impracticable to measure any such value. As to the grantee any positive element may, for practical purposes, be deemed to be largely or wholly offset by the negative effect of the restrictions ordinarily present in options of the type under discussion. From the viewpoint of the grantor corporation no measurable cost can be said to have been incurred because it could not at the grant date have realized more than the *fair value* of the optioned shares, the concept of fair value as here used encompassing the possibility and prospect of future developments. On the other hand, it follows in the opinion of the committee that the value to the grantee and the related cost to the corporation of a restricted right to purchase shares at a price *below* the fair value of the shares at the grant date may for the purposes here under discussion be taken as the excess of the then fair value of the shares over the option price.

13. While market quotations of shares are an important and often a principal factor in determining the fair value of shares, market quotations at a given date are not necessarily conclusive evidence.[3] Where significant market quotations cannot be obtained, other recognized methods of valuation have to be used. Furthermore, in determining the fair value of shares for the purpose of measuring the cost incurred by a corporation in the issuance of an option, it is appropriate to take into consideration such modifying factors as the range of quotations over a reasonable period and the fact that the corporation by selling shares pursuant to an option may avoid some or all of the expenses otherwise incurred in a sale of shares. The absence of a ready market, as in the case of shares of closely-held corporations, should also be taken into account and may require the use of other means of arriving at fair value than by reference to an occasional market quotation or sale of the security.

### Other Considerations

14. If the period for which payment for services is being made by the issuance of the stock option is not specifically indicated in the offer or agreement, the value of the option should be apportioned over the period of service for which the payment of the compensation seems appropriate in the existing circumstances. Accrual of the compensation over the period selected should be made by means of charges against the income account. Upon exercise of an option the sum of the cash received and the amount of the charge to income should be accounted for as the consideration received on issuance of the stock.

15. In connection with financial statements, disclosure should be made as to the status of the option or plan at the end of the period of report, including the number of shares under option, the option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof.

*The statement entitled "Accounting for Compensation Involved in Stock Option and Stock Purchase Plans" was adopted by the assenting votes of nineteen members of the committee, of whom two, Messrs. Mason and Smith, assented with qualification. One member, Mr. Knight, did not vote.*

Mr. Mason assented only under the assumption that if an option lapses after the grantee becomes entitled to exercise it, the related compensation shall be treated as a contribution by the grantee to the capital of the grantor.

Mr. Smith assented to the bulletin but deprecates the failure to recommend disposition of the credit arising from compensation charges in the case of lapsed options. He believes that the failure of the committee to do so is not in the best interest of the profession generally, and may lead to diverse treatments inimical to good accounting practice.

### NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

[3] Whether treasury or unissued shares are to be used to fulfill the obligation is not material to a determination of value.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

COMMITTEE ON ACCOUNTING PROCEDURE (1952-1953)

PAUL K. KNIGHT, *Chairman*
FREDRICK B. ANDREWS
FRANK S. CALKINS
H. A. FINNEY
ROY F. GODFREY
THOMAS G. HIGGINS
JOHN A. LINDQUIST
PERRY MASON
EDWARD F. McCORMACK
JOHN PEOPLES
MAURICE E. PELOUBET
JOHN W. QUEENAN
WALTER L. SCHAFFER
C. AUBREY SMITH
C. OLIVER WELLINGTON
WILLIAM W. WERNTZ
EDWARD B. WILCOX
RAYMOND D. WILLARD
ROBERT W. WILLIAMS
KARL R. ZIMMERMANN

CARMAN G. BLOUGH
*Director of Research*

## The Incorporators of the New York State Society of CPAs

(Continued from page 221)

counts during his membership in it of 7 years or more; that probably he knew fewer members of the Association; that he was well acquainted with Harney and MacRae of the Institute, perhaps also with Sargent, and specially with Gottsberger, then a member of the Association.

These facts do not prove, but they very strongly suggest, that Hourigan selected the Incorporators; and that may have been the reason that he was chosen for Vice President at the organization meeting of the State Society on March 30, 1897.

Others, many others, participated in its growth and development. But unless and until other facts prior to its incorporation come to light it seems that the credit for taking the first steps for the organization of the New York State Society of Certified Public Accountants should be accorded to the Albany CPA, John Hourigan.

## AN ADIRONDACK VIEW

**Chapters.** A new chapter is being born—Staten Island. It's our first child since the illegitimate (according to quondam President Saul Levy) Adirondack Chapter. Probably this new child will be a serious little cuss—just as a matter of change. We hope it will be wise—being serious won't guarantee that though—the king's fool was often wiser than the king.

It won't be long now before there will be others. The Long Island Chapter for the commuters on that famous railroad. The Trinity Chapter for the folks around Wall Street. The Grand Central Chapter for the 42nd Street section. The Croton Chapter for Westchester CPAs and their reservoirs. And the Rip Van Winkle Chapter for Hudson River habitues.

This all because the Staten Island ferry isn't anything to brag about. Thus do little things make big differences. Bon voyage to you—Staten I!

LEONARD HOUGHTON, CPA
Of the Adirondack "Chapter"



PRINTED IN U.S.A.
208

ain a
g for
does
ntant
ed as
s.
felt,
umed

X
LARD
AMS
IANN

GH
*arch*

or-
ciety

ed in
un-
o its
eems
steps
York
Ac-
the

since
pter.
We
was

for
ound
oton
apter

s do

."